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OFHEO RISK-BASED CAPITAL STRESS TEST FOR FANNIE MAE AND FREDDIE MAC

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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OFHEO RISK-BASED CAPITAL STRESS TEST FOR FANNIE MAE AND FREDDIE MAC

Tuesday, July 23, 2002

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 2:15 p.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ney, Shays, Gillmor, Lucas of Oklahoma, Oxley, Rogers, Bentsen, Maloney, Ford, Lucas of Kentucky, and Israel.

Mr. BAKER. [Presiding.] I would like to call this meeting of the Capital Market Subcommittee to order.

Today the Subcommittee meets to discuss the long-awaited results of OFHEO's risk-based capital rules for the housing government-sponsored enterprises Fannie Mae and Freddie Mac.

The importance of this long-awaited test cannot be over emphasized because essentially what is at stake—giving both investors and taxpayers—is the clearest possible financial picture of the two government-backed companies with, today, having a combined debt of over $1 trillion, implicitly linked to taxpayer pockets.

Because of this importance, and in the context of the current market environment, demanding unprecedented fullness, accuracy and integrity in financial disclosure, I feel it important to recount the history behind the risk-based capital test and how we have, at long last, arrived here today.

In 1992, a legislative act directed OFHEO to issue a risk-based capital rule within 18 months after the appointment of the director, in effect, by the end of 1994. OFHEO proposed rules for public comment, accordingly, in 1995, 1996 and 1999. In 1999, the proposed rule issued for comment actually included a table showing the required risk-based capital calculations for Fannie and Freddie as of September 30, 1996 and June 30, 1997.

Interestingly enough, on both occasions, Fannie Mae had a deficit, while Freddie had a surplus on both accounts. Saying it another way, one GSE failed the proposed test as early as 1996 and 1997.

On August 1st of 2001, Director Falcon testified that OFHEO would publish in early 2002 how the enterprises would fair under the rule then promulgated using fourth quarter, 2001 data.

Subsequently, on September 13, 2001, OFHEO finalized the risk-based capital rule. However, due to apparent complications, by December 11th of 2001, OFHEO announced in light of the proposed changes in the rule, the agency would, instead, use first quarter 2002 numbers to calculate how the enterprises were gauged.

Finally, after a ten-year process, OFHEO announced the results of its amended rule for the first quarter 2002, using the amended test, showing that both Fannie and Freddie had easily passed.

We can be pleased with that report, but it was as we all should have expected in light of this important statement made by Director Falcon prior to announcing the results. with the proposed rule in referencing June of 1999, the enterprises then began a program of managing their activities to ensure they would meet the requirements of the rule. I take that to mean in the middle of 1999 the enterprises were advised and prepared to initiate business strategies to comply with any rule subsequently issued by OFHEO.

What is of importance to me today is to understand at least what changes were made in the rule initially promulgated that resulted in an additional delay in its implementation. Were the changes the result of the failure of either the GSEs to pass the test? Or was it an underlying failure in the adequacy of the test?

Was the eight-and-three-quarter year period that developed the first test, subsequently modified in the 60 days following, was the result of running the test and determining that either GSE did not meet the minimal capital standards?

Did either GSE request specific modifications?

In my request of Director Falcon and OFHEO earlier this year, I specifically requested that the test be conducted in four different methodologies—prior to its modification in December; as promulgated after eight-and-a-half years of work on the last quarter of 2001; the first quarter of 2002; and, additionally, after the modification, as proposed by OFHEO on the same data set.

It is my understanding in response to that request, the agency indicated that the data for the 2002 first quarter could be released publicly, but specific request was made of me in the committee not to release the information promulgated on the fourth quarter of 2001, specifically using the pre-amendment test.

I am curious as to why that request was deemed to be confidential in the first place. I am understanding that the explanation was that the agencies were not managing to the standards of that test. I simply refer to the quote of the Director in 2002, which indicates, "With the proposal of the rule in June 1999, the enterprises began a program of managing their activities to ensure they would meet the requirements of the rule."

Why is it so hard to get professional assessment of the enterprises that are so important to our economy without political manipulation? Taxpayers may or may not be at risk. We honestly just do not know. But in this environment of corporate questioning, where every accounting rule is studied and re-studied, where every CEO is questioned and re-questioned, are there those who suggest that these two corporations, so vital to our economic success, are above questioning?

I hope not.

I would recognize Mr. Bentsen, now, for an opening statement.

Mr. BENTSEN. I thank the chairman for recognizing me. And I thank him for calling this hearing today.

The subcommittee will hear from Director Armando Falcon, the director of the Office of Federal Housing Enterprise Oversight on the final risk-based capital rule for Fannie Mae and Freddie Mac. And we are pleased to welcome Mr. Falcon back to the committee, of which he is a graduate as a former counsel to this committee.

As the chairman mentioned, OFHEO was created in 1990 to act. And I would note that Mr. Falcon and his predecessor have undertaken, in many respects, not without criticism, a Herculean task of creating this risk-based capital rule and the analysis to go along with it. And doing it with a number of congressionally-mandated strictures that would not, otherwise, be in place for other types of analysis that are done within the market.

I think it is also important that we hear from Mr. Falcon today because over the last several years, as we have had debates over the issue of the GSEs, often OFHEO has been overlooked as they have been toiling away and trying to come up with this rule.

And I would also just remind the chairman that while there may be concern among some that the GSEs are managing their activities in order to meet the requirements of the rule, in fact, that is the whole idea of having rules, whether they are risk-based capital rules for GSEs or for banks for thrifts or for any other institution is, in fact, you want them to manage their operations in order to meet the confines of the rule.

So, Mr. Chairman, I am glad to hear from Mr. Falcon today, look forward to his testimony and the opportunity to question him on the issues that you have raised and others.

And I yield back.

Mr. BAKER. Thank you, Mr. Bentsen.

Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman.

Thank you for holding this—

Mr. BAKER. Oh, I am sorry.

Chairman Oxley, did you wish to be recognized at this time?

Yield to Mr. Ney?

Yes, sir?

Mr. NEY. I am pleased that the committee has had a chance to review the final risk-based capital rule for Fannie Mae and Freddie Mac. This capital standard has been a long time coming and we are grateful that the process has now been concluded.

We look forward to this rule being enforceable, hopefully, in the months ahead.

The risk-based capital rule is designed to ensure that GSEs can survive the worst of housing downturns, with high credit losses and huge moves in interest rates over, basically, a ten-year period.

This risk-based capital is unique because it requires the GSEs to operate their businesses in a way that creates an incentive for risk reduction activities. And I think it should be, really, a model for all companies these days.

It is important for this subcommittee to realize, and I know they do, that the risk-based capital standard is just one piece of an overall safety and soundness regime for these congressionally chartered companies. To be clear, after the 1992 legislation, both of these

companies were bound by minimum capital standards and continuous on-site examinations.

Long before Enron and WorldCom, in October 2000, Fannie Mae and Freddie Mac announced six initiatives that the financial markets now rely upon to maximize financial transparency and market discipline. Unlike many other companies, these two companies have signed up for the annual credit rating; additional interest rate and credit risk disclosures; additional liquidity management; interim implementation of the risk-based capital standard; and the issuance of subordinated debt.

Less than two weeks ago, I did join SEC Chairman Harvey Pitt and Fannie and Freddie for an announcement where the two companies agreed to register their common stock under the 1934 SEC Act, which now binds these two companies to comply with SEC requirements for periodic corporate financial disclosures. In the press interviews after the announcement, Frank Raines committed on CNBC that Fannie Mae will—and I stress will—certify 2001 financial statements by mid-August, just as SEC Chairman Harvey Pitt has asked of the top 1,000 publicly traded companies in this country to do.

In addition, I was pleased to hear this morning new light about the fact that both companies have announced they are recommending to their boards of directors that they begin expensing all stock-based compensation. In the current economic environment, few other companies are stepping up to the plate to lead on financial disclosure and transparency in the way I think these two are, although I predict many companies will with what is going on now in the United States.

And, Mr. Chairman, I just want to, again, congratulate you, Chairman Baker, for all your work and I look forward to hearing Director Falcon.

Thank you.

Mr. BAKER. Thank you, Mr. Ney

[The prepared statement of Hon. Bob W. Ney can be found on page XX in the appendix.]

Mr. Ford, did you have an opening statement?

Mr. FORD. Chairman, I will defer to the witness and have statements once he finishes.

Mr. BAKER. Thank you, Mr. Ford.

Mr. Shays?

Oh, excuse me, sir, Chairman Oxley?

Mr. OXLEY. Thank you, Mr. Chairman.

And thank you for your leadership on this important issue.

The Capital Market Subcommittee meets this afternoon to consider the new risk-based capital rule for Fannie Mae and Freddie Mac, which has been finalized by the regulator, the Office of Federal Housing Enterprise Oversight.

OFHEO is responsible for ensuring that Fannie Mae and Freddie Mac are adequately capitalized and operating safely.

The 1992 act which created OFHEO directed the agency to issue a risk-based capital rule tied to an enterprise's risk exposure, as well as the current leverage or capital rule is a minimum percentage of assets.

I am pleased to welcome OFHEO's director, Armando Falcon, look forward to his presentation of the initial non-binding stress test results for the enterprises.

And I encourage you to work, Mr. Falcon, with this committee as OFHEO moves ahead later this year to implement and enforce the risk-based capital rule. It is important that both the risk-based and leverage capital requirements are in place and being implemented in tandem so that Fannie and Freddie can continue to perform their housing mission in a safe and sound manner.

In addition, I would like to hear from you about what actions OFHEO will take in conjunction with the SEC to facilitate implementation of the voluntary compliance by Fannie and Freddie with SEC disclosure requirements under the Securities and Exchange Act of 1934, and to review the adequacy of information disclosures related to mortgage-backed securities.

Mr. Chairman, this will be an important next step in the series of hearings that you have conducted. And I look forward to the response from the director.

I yield back.

Mr. BAKER. I thank you, Mr. Chairman.

Mr. Israel, did you have an opening statement?

Mr. ISRAEL. Mr. Chairman, I will insert my statement for the record.

[The prepared statement of Hon. Steve J. Israel can be found on page XX in the appendix.]

Mr. BAKER. Thank you, Mr. Israel.

Mr. Shays?

Mr. SHAYS. Thank you, Mr. Chairman.

Mr. Chairman, thank you for holding these hearings. Mr. Oxley, for your fine work as chairman of this committee.

I also welcome Mr. Falcon, director of OFHEO. I appreciate that he is here and I look forward to his testimony.

I think with Mr. Falcon, we have, yet, another witness who recognizes that voluntary disclosure is not good enough, that disclosures need to be reviewed by the SEC for inadequacies. And, in other words, Fannie and Freddie will no longer act as their own securities regulator. And I emphasize that.

The recent announcement that these two mortgage giants, Fannie Mae and Freddie Mac, will come under the SEC as it relates to the 1934 law is a huge turning point in the debate. And I congratulate them and the SEC and OFHEO for whatever involvement they had with this. But it does not relieve me of some of the questions that I still have and the committee still has.

I think first and foremost, we need to know how these new disclosure requirements will be enforced and OFHEO's role in the rule making.

Second, we need to know what are the policy reasons behind the continuing exclusion of Fannie Mae and Freddie Mac's mortgage-backed securities and debt securities from the full registration and disclosure requirements of the securities law.

Third, I think we need to know how did the administration reach this agreement with Fannie Mae and Freddie Mac, since I know of no precedent in which the publicly traded companies dictate to government regulators what laws they will comply with.

And finally, I look forward to discussing Fannie and Freddie's safety and soundness and the results of the risk-based capital stress test with our director.

Thanks.

Mr. BAKER. Thank you, Mr. Shays.

Mr. Ford has reconsidered and would like to take advantage of his time.

Mr. Ford?

Mr. FORD. It is just for 30 seconds, Mr. Chairman.

I, too, look forward—it was really Chairman Oxley's comments that spurred some thought on my part. So I appreciate his inspiration.

Last week, as all of know, we held a hearing on both Fannie and Freddie's voluntary agreement to register their common stock with SEC. And I just wanted to point out—if someone already has not today—I know both of them have taken the bold voluntary step of announcing they will account stock option compensation as an expense against earnings. They are joining a growing number of companies in taking this step to enhance transparency and to inform shareholders.

With these voluntary disclosures, Fannie and Freddie can focus, or continue to focus, on their primary mission, which is making home ownership available to all Americans. The home ownership rate is now 68 percent, at its highest level ever. And this is due, in no small part, to the liquidity that these two companies have provided to the primary mortgage market.

I look forward to hearing from our witness today. And I look forward to doing all I can to ensure that Mr. Baker's concerns are addressed and that these two organizations can continue to provide home ownership opportunities for millions of Americans.

Thank you.

Mr. BAKER. Thank you very much, Mr. Ford.

Mr. Rogers?

Mr. ROGERS. Thank you, Mr. Chairman.

I want to thank you for having these hearings.

And I want to thank this committee, under the leadership of Mr. Oxley and Marge Roukema, for already taking a huge step in home ownership. And today we are going to talk about regulations. We are going to talk about stress tests and common stock registrations, maybe—I mean, we may touch on those issues.

But more importantly, when you get done with all of the technical parts of providing home ownership, the bottom line is what are we doing to provide the opportunity, including access to capital, for those who are trying to get into homes?

And if we cannot take this to the lowest common denominator, we will never be successful.

And I appreciate Fannie Mae and Freddie Mac's work in what they do and try to penetrate communities, especially under-served communities for having access to capital and getting into homes.

And I look forward to your comments. And I suppose it is for us to wrestle over the details so that those individuals back home do not have to, that they can walk to that place, get access to that capital and have the joy of putting that key in the door and turning the key.

And, again, under the leadership of this committee, as a whole, under Mr. Oxley, Mr. Baker, Mrs. Roukema, we have taken a huge step in improving the chances for most Americans to get into those homes.

And I hope through the whole course of this we do not lose sight of that and the good work that both Fannie Mae and Freddie Mac have done and the better things that we can do to make sure that they are a stable force in the community to keep providing the access to that capital.

And I would yield back the remainder of my time.

Thank you, Mr. Chair.

Mr. BAKER. Thank you, Mr. Rogers.

If there are no further opening statements, I wish to welcome back—no stranger to the committee—the Director of OFHEO, Mr. Armando Falcon.

Welcome, Mr. Director.

You will need to pull that microphone very close. We are having a hard time. Check the little button right down on the bottom; see if that does it.

Mr. FALCON. How about this?

Mr. BAKER. Now, you are cooking.

STATEMENT OF ARMANDO FALCON, JR., DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Mr. FALCON. All right.

Mr. Chairman, Congressman Bentsen and members of the subcommittee, I am pleased to be here today to report to you on OFHEO's activities and the safety and soundness of Fannie Mae and Freddie Mac.

This is an important time in the short history of the agency, as OFHEO has just entered its 10th year. OFHEO began operating when its first employee, the first director, took office on June 1, 1993.

The agency was built from the ground up and had to acquire staff and address hundreds of administrative issues involved in establishing an agency infrastructure. OFHEO needed to procure office space, equipment, computers, telecommunications and other logistical support for the lawyers, economists, examiners and administrative personnel who would carry out the duties of the agency.

In its early years, OFHEO's experienced staff worked to develop an in-depth understanding of the operations of the enterprises. OFHEO grew from a one-person agency into a strong and well-rounded regulator, fully capable of meeting its regulatory responsibilities.

While the agency was being built, it was still obligated to fulfill its mission of regulating two extremely large and complex financial institutions. OFHEO's mandate is to ensure that the enterprises are safe and sound and adequately capitalized. In so doing, OFHEO helps ensure that the enterprises are able to provide liquidity to the mortgage markets and promote home ownership.

I am pleased to report that OFHEO is meeting its mandates. We have found the enterprises to be safe and sound and adequately

capitalized. The enterprises are providing unprecedented levels of liquidity and stability to the mortgage and housing markets.

OFHEO looks forward to its second decade of pubic service.

OFHEO's regulatory regime consists of three pillars. These are examination, capital standards and research. I will refer the subcommittee to my written testimony for a discussion of these topics and will use the remainder of my time to focus on the risk-based capital rule and disclosure.

OFHEO's risk-based capital standard is unique among financial regulators. Unlike ratio-based capital standards, OFHEO's standard is based on a 10-year stress test. A stress test measures risk in the context of a company's overall portfolio, including the company's risk management activities. An enterprise can comply with OFHEO's risk-based capital standard by reducing risk or raising capital or a combination of both.

The risk-based capital rule became effective last September. At that time, I appeared before this committee—the subcommittee—and was urged to consider whether refinements to the rule were necessary and, if so, to act quickly. I subsequently determined that modifications were appropriate and the rule was amended after a public rule making during the fourth quarter of last year.

We will use the rule to classify the enterprises, beginning with the third quarter of this year.

In the interest of public disclosure and regulatory transparency, last month, OFHEO released the results of the risk-based capital test using the first quarter 2002 enterprise financial data.

Attached to my testimony is the press release announcing the results.

Both enterprises passed the stress test, due to effective risk management, including extensive interest rate hedging and the first quarter's economic environment. Interest rates are low; home values are rising; and borrower defaults are minimal. An enterprises risk-based capital requirements will vary from quarter to quarter, depending on the enterprises risk management decisions and market conditions.

I have taken a very open approach to the implementation of these stress tests. I decided to release the actual stress test computer model or source code to the public. In addition, I rejected an interpretation of the one-year implementation period, which would have precluded the release of any results during that time period.

And when I announced the stress results for the first quarter of this year, I did not just issue a pass-fail notice. I released the full results for both upright and downright scenarios.

However, that openness must be balanced with some caution to ensure that no misleading information enters the public domain. That is why OFHEO will not be releasing to the public any stress test results other than the official quarterly announcements. That, of course, does not override this subcommittee's right to information.

And so, I have promptly, ahead of schedule, supplied the subcommittee with all of the information it has requested. My only request was that the subcommittee respect the confidentiality of the information.

OFHEO considers this information confidential for a variety of legal reasons. But superior to all those considerations is concern about releasing misleading information about the enterprises financial condition that could disrupt the markets.

We have developed a strong, rigorous risk-based capital standard. Now, the enterprises have one year to adapt and be in compliance before we enforce it.

Congress wanted us to set up a new capital standard, not a trap. That is why it would be inappropriate to release results before the rule, as amended, was in place.

I will now turn to corporate disclosure. OFHEO safety and soundness responsibility includes an obligation to ensure that the enterprise financial disclosures are adequate. Our agency began the comprehensive review of enterprise disclosure in April of 2002. In May, OMB requested that OFHEO specifically consider a rule that would ensure enterprise financial disclosures were comparable to those of other publicly held companies.

In June, I responded to OMB's letter. I agreed that voluntary compliance was inadequate and that given the enterprises exemptions from the securities laws, OFHEO needed to promulgate enforceable rules in this area.

I am pleased that OFHEO's objective will now be accomplished in a most efficient manner. The enterprises voluntarily agreed to subject themselves to mandatory regulation by the SEC under the Securities and Exchange Act of 1934.

I would like to highlight several key points about the agreement. The enterprises will become registered companies bound by the 1934 act. Absent the agreement, OFHEO would have adopted its own disclosure regime, based on the securities laws.

Second, and most significant, the disclosures will be reviewed by the SEC and OFHEO. Currently, it is the enterprises that determine what corporate information is material and must be disclosed. Once registered, that will change and the ultimate arbitrator of what must be disclosed will be the SEC and OFHEO, acting in the public interest.

Finally, the disclosure reports will be available from the SEC essential repository for corporate disclosure reports of all registered companies.

In order to facilitate the application of the 1934 act to the enterprises, OFHEO will promulgate the rule concerning the filing of all required periodic reports. Registration with the SEC does not, in any way, limit OFHEO's ability to act in the interest of safety and soundness. In fact, as part of the rule I have mentioned, OFHEO is considering requiring supplemental disclosures beyond those required by the SEC.

In addition, OFHEO, the SEC and Treasury will conduct a review of disclosures relating to the offering of mortgage-backed securities by the enterprises and other issuers. The review will consider the appropriate manner for creating a more level playing field and greater comparability of disclosures that will enhance enterprise safety and soundness.

I will note that OFHEO's goal is disclosure, not registration. After all, disclosure is the rationale underlying registration. Accordingly, OFHEO will not pursue a registration regime at this

time. if our disclosures can be met without registration, and I am confident that they can be, then registration is unnecessary. However, until the review is completed, OFHEO, as the safety and soundness regulator, cannot and should not rule out registration in some form as a possibility.

In response to the subcommittee's request last week, I have conferred with the SEC and Treasury and we have agreed to make every effort to complete the review by year end.

Mr. Chairman, you have been a strong supporter of our budget requests in the past and have indicated support for permanent funding of OFHEO. OFHEO, as the agency responsible for the financial health of two companies with combined credit exposure of a little over $3 trillion, should be permanently funded, as are the other safety and soundness regulators. There is simply too much at stake not to take this prudent step.

The administration supports this in its fiscal year 2003 budget request for OFHEO. I urge the subcommittee to support legislation that would bring about this result.

In conclusion, as I stated earlier, Fannie Mae and Freddie Mac are safe and sound and well capitalized. We all can see their financial health at the beginning of any discussion about them. We are able to have this discussion against such a healthy backdrop due, in part, to the hard work of OFHEO's employees. I do not mean to minimize the efforts of the enterprises' management, but through our regulatory program we constantly probe for weaknesses and vulnerabilities and assure that the enterprises maintain the highest standards of sound management.

We have a state-of-the-art risk-based capital rule in place. We are expanding our examination program, building our regulatory infrastructure and conducting valuable research. The OFHEO of 2002, which I am proud to direct, gets the job done.

Thank you, Mr. Chairman. And I look forward to answering any questions the subcommittee may have.

[The prepared statement of Armando Falcon Jr. can be found on page XX in the appendix.]

Mr. BAKER. Thank you, Mr. Falcon.

I do appreciate your willingness to appear here today and certainly understand the complexity and difficulty of establishing a test for what are very large and complex organizations.

But I want to make it clear that my line of questioning today results from a great deal of frustration about the process and where I think we find ourselves, as of this moment.

It took eight-and-a-half years and considerable encouragement from the committee and others, including defense of appropriations process, to make sure that OFHEO had the resources to ultimately prepare the most professional analysis possible for this committee and for the benefit of taxpayers.

I find it troubling that at the end of that eight-and-a-half year period, we then had an approximately 60-day period, of which I am told by the agency it was a result of my request asking you to be thorough and thoughtful in the process, that it took as long as it did to make the subsequent modification, resulting in the post-amendment stress test, as we have it today.

As I understand it, the elements that were involved in that critical analysis related to the level of haircut, as opposed to AA rated—AAA rated mortgage insurance companies; funding costs; and certain multi-housing questions; and perhaps technical issues.

Were there any other elements in the modification to the eight-and-a-half year test made by the 60-day test that I am not aware of, other than those four principle areas? And I will recite them again: AA, AAA haircut mortgage insurance companies; multi-housing issues; funding costs; and technical issues.

Mr. FALCON. I believe that covers all of them, Mr. Chairman.

The technical issues: I want to get into more detail later about what was in those technical details. Some might have risen to the level of more than just technical. Others may have been truly technical.

Mr. BAKER. So it is your testimony that those, in general—and I am using "technical" as defined by the agency in my discussions with agency personnel.

Three principles were as outlined and then dogs and cats were described as technical issues. And so I am saying in that context, those are the four areas in which the modifications were made resulting in the test that is finally to be promulgated?

Mr. FALCON. Yes. I believe that is right.

Mr. BAKER. Did you have staff run the test prior to its final promulgation, prior to the modification? In other words, the September developed test, which was then subsequently modified December-January, was that test run by the agency and producing results before it was made public?

Mr. FALCON. The version that was final pre-amendment, Mr. Chairman? Is that the one you are talking about?

Mr. BAKER. Pre-amendment.

Mr. FALCON. We had a—yes—a working version of the computer code. We did.

Mr. BAKER. And what were the results, not in specific detail, but in generic terms? Were there difficulties with the way in which the test concluded its analysis? Were either of the GSEs or both GSEs found to have difficulties with that test? What is your remembrance of what happened with that pre-amendment test?

Mr. FALCON. There were many bugs that were being worked out at that time, Mr. Chairman.

Mr. BAKER. Was one of the bugs the result? Or be more specific.

Mr. FALCON. You could not get an accurate result if you did not have the bugs worked out. The bugs were two times, primarily. The bugs were with the computer code, itself, as well as getting the data right so that it would plug into the computer code and then produce an accurate number.

Mr. BAKER. So once you got the bugs of the computer code behind you, let's assume we have a de-bugged test, built on the principles which you have enunciated, were there further modifications beyond the de-bugging?

Mr. FALCON. We have been doing some de-bugging for the past—

Mr. BAKER. I understand, but what—

Mr. FALCON. —beyond September.

Mr. BAKER. Let's put the bugs on the shelf. We found the major bugs and we might have had a small bug or two remaining that were later to be discovered.

As of September 2001, bug issue principally resolved, were there other elements that were of concern to the agency that needed to be modified?

Mr. FALCON. Well, I would not say that the bugs were resolved after September 1. We continued to resolve bugs after that point.

Mr. BAKER. Okay. Well, I give you bugs, too. Let's assume there are bugs and bugs B; were there other issues besides bugs and bugs B that were of concern?

Mr. FALCON. As far as the computer model working?

Mr. BAKER. No.

Mr. FALCON. No?

Mr. BAKER. Forget the computer. We are off of computer. We are off of bugs, bugs one, bugs two. We are now on to factual determinations beyond bugs, as in the case of the amount of haircut for AA versus AAA, as in multi-housing adjustments, as in funding cost adjustment, any other adjustment.

Mr. FALCON. I mean, there are a variety of issues and they are referenced in the risk-based capital rule, both in the final rule where we indicate areas of further research—

Mr. BAKER. Well, let me ask it a different way. Did you consult or did the GSEs consult with you prior to the promulgation of the final rule and such consultation resulting in any modification to the final promulgated rule?

Mr. FALCON. When we announced that we were going to amend this rule, we received comments from many interested parties about the rule. That is pursuant to notice and comment process.

Mr. BAKER. Sure. No. I am not suggesting anything inappropriate. I am trying to find out the facts.

Did Freddie review the rule and its function and make recommendations to you for modification, on which you subsequently acted?

Mr. FALCON. No.

Mr. BAKER. Okay. Thank you.

Is it your view that the changes made in the post-amendment rule were primarily technical in nature and that did not have any substantive change that would either detract or enhance the GSE's capital adequacy?

Mr. FALCON. It is a little difficult for me to track of the exact time period and version of the rule you are making reference to, Mr. Chairman.

Mr. BAKER. The final rule.

Mr. FALCON. The final rule, the post-amendment?

Mr. BAKER. Correct.

Mr. FALCON. And I am sorry, but the question regarding the post-amendment rule?

Mr. BAKER. Were there any modifications made to the post-amendment rule that, in your judgment, would result in a significant capital adjustment in the conclusions the test would reach?

Mr. FALCON. For which quarter?

Mr. BAKER. Any quarter, whatever makes you happy.

Mr. FALCON. Okay. There were still various modeling issues that we were working out related to various activities of the enterprises. There were some issues with respect to remmicks and swaptions, I think was an area that we were working at, coming to the final conclusion and getting the final bugs worked out in a few areas like those.

Mr. BAKER. Okay. Well, let me go at it another way. When I wrote you in February, I suggested that the test be run four ways: pre-amendment; post-amendment; each test last quarter 2001; first quarter 2002. You have achieved that; I got the results for fourth quarter pre-amendment test yesterday. And for that I thank you.

In the letter responding to me on both instances, you indicated that we should treat or your request of the committee was to treat those calculations as confidential.

I direct your attention to the 1999 test in which Fannie was found, under your promulgation, not to meet the minimum requirement. That is the 1999 data promulgated and published by your pre-amendment rule discussion.

If you could print and publish that in 1999, showing there is a deficiency, what is the distinction between releasing the information you have given to the committee today and the 1999 publication, which you issued?

Mr. FALCON. Mr. Chairman, at that time, it was essential. In order to allow full notice and comment, it was essential to release to the public some information about the way the rule works, the release of not just results. In 1999 we released results based on 1997 data.

In order to allow robust notice and comment, we needed to give the public some indication about not just results, but also sensitivity analysis.

And so what we had in the proposed rule was not just results, but we broke it down for the public among various types of risk and showed what the sensitivity of the stress test was as allocated among different types of risk.

Mr. BAKER. One more question because I have exceeded my time.

Have you, prior to the hearing today, released the data to any other third party, any members of Congress, anybody else besides my office and yours?

Mr. FALCON. The enterprises have a working version of the code, Mr. Chairman—

Mr. BAKER. The specific question is, the answer to the letter I wrote in February, which you responded and said, "We will provide you with the information," which you provided the last piece of which to the committee as of yesterday—

Mr. FALCON. Yes.

Mr. BAKER. —has that information—four parts—been released to anyone else other than my office, as of this moment?

Mr. FALCON. No. It has not even been released to the enterprises, Mr. Chairman.

Mr. BAKER. Well, I have been told other members of Congress have it.

Mr. Bentsen?

Mr. FALCON. Mr. Chairman, may I correct myself in the form that we did give the information to Congressman Kanjorski?

Mr. BAKER. Okay. And nobody else?

Mr. FALCON. No, sir.

Mr. BAKER. Thank you.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Falcon, the first quarter numbers that you released and the fourth quarter numbers that Mr. Baker and Mr. Kanjorski have, which I do not, under the post-amendment rules—well, the fourth quarter would be commensurate with the first quarter of 2002, is that accurate?

Mr. FALCON. Right. The chairman has numbers that he has requested and we have supplied to him which applies the stress test to the fourth quarter. And we released, publicly, results applying to the first quarter of this year.

Mr. BENTSEN. All right.

The chairman seems to be raising a concern about what numbers pre-amendment versus post-amendment might look like with respect to Fannie or Freddie. I guess I would ask you from your interpretation of the law, the 1992 act and the administrative procedures act that governs your rule making process, I assume, the post-amendment rule is the rule.

Mr. FALCON. Yes.

Mr. BENTSEN. And so for purposes of how OFHEO should conduct its stress test, under the law, it should use the post-amendment rule. Is that right?

Mr. FALCON. Yes, Congressman.

Mr. BENTSEN. And so the amendments that were made to the rule are what those, you know, the haircuts and the servicing ratings and issues that you and the chairman conversed on; those are the changes, some of which were brought up in an earlier hearing before this subcommittee. So nothing, just to reiterate what you—restate from what you responded to the chairman in the earlier line of questioning, there is nothing new here, in the amendments, that should be a surprise to anyone on this committee. Is that correct?

Mr. FALCON. All the changes we made to the rule were done pursuant to notice and comment. We issued a proposed amendment to the rule as it stood in September. And, in fact, I was urged to make any changes only pursuant to notice and comment, and I fully agreed with that.

We put out for public comment the changes that we were contemplating, received comment from many parties and then proceeded with what we thought was the right thing to do in crafting this risk-based capital rule.

Mr. BENTSEN. So to argue that numbers that are run using an unfinished rule are somehow indicative of the financial condition of one of the GSEs on their face would be inaccurate because that is not what the rule is, right? I mean, the rule is what the final published rule, after the amendments, is—I mean, that is what it is, right?

Mr. FALCON. Right. That is what is currently in effect.

Mr. BENTSEN. And that is the rule that the GSEs will be required to manage their operations accordingly. And then the third quarter or after the third quarter when you begin to classify the GSEs, then they will be required if they are not already, will then

be required to come into compliance at any time they are out of that.

Mr. FALCON. Right.

Some might argue that the one-year implementation period would mean that there should not be any results released until the one-year period ends. I have taken a more open approach to that and have said, in fact, and released numbers and that I would release numbers as soon as the rules were clearly in place.

And since the rule was subject to amendment in the fourth quarter of last year, the rules were not clearly in place. We published the final rule in the fourth quarter of last year. so the rules were in place at that time. And that is why I said that we would release results for the first quarter of 2002.

Mr. BENTSEN. Upon issuance of the final rule, was there comment or much comment, subsequent to that, criticizing the standards that are being used? I mean, it is the accepted rule; it is under the APA. It is the law or it is the regulation. But I mean, is there still criticism of that, of the standards that are being used?

Mr. FALCON. Every so often you might hear some criticism about the rules. Some think it is too lenient, some think it is too tough. What we have done is craft a rule which closely ties capital to risk. It is based on sound, historical analysis, historical data and our best judgment about the risk associated with all the different activities at the enterprises.

I think it is a very strong, robust rule. And I am proud of the work the agency did to put this together. It has never been done before by any regulator.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Mr. BAKER. Thank you, Mr. Bentsen.

Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman.

The question I had—I know you have had a lot of wrangling at yourself by others for a delay of a risk-based capital standard. But it was written in 1992. It was conceived on the heels of the savings and loan and really was constructed to look at a financial collapse of the like we have never seen. And I think that, you know, was part of it.

The model measures depression-like credit risk fluctuations and then adds another I think it is 30 percent for operational risk.

Are any other financial service companies subjected to a risk-based capital test comparable to what GSEs now face?

Mr. FALCON. Thank you, Congressman. That is a good question. This is unique among capital standards for any regulator. It is one that was mandated by Congress.

Other financial institutions like banks and thrifts have a risk-based capital standard, but that is more of a risk-weighted leverage type standard. This is unique because it places the enterprises' balance sheets under severe economic stress and requires, through a financial simulation model, that they hold enough stress over that 10-year period, every quarter in that period such that they never become under-capitalized at any point during the 10-year period.

This is unique. It has not been done by any other regulator up to now. I am proud of what the agency has accomplished.

Mr. NEY. Well, like I said, I think you have done good. It is just I know you got a lot of heat getting there.

Mr. FALCON. Yes.

Mr. NEY. So—

Thank you, Mr. Chairman.

Mr. FALCON. Thank you.

Mr. BAKER. Thank you, Mr. Ney.

Mr. Ford?

Mr. FORD. Let me sort of walk back through just one or two things. They passed the test; is that what you are saying?

Mr. FALCON. Yes, Congressman. For the first quarter of 2002, the only numbers we have released, they do pass the test.

Mr. FORD. And you will not release the fourth quarter numbers, again, for what reason?

Mr. FALCON. The standard I have set is that I was going to release the results for the first quarter after which all the rules were in place. Since this rule was subject to an amendment in the fall of 2001, the first quarter for which the rules were in place would be that first quarter of 2002. That is why that is the first quarter that we have released.

Mr. FORD. So, in other words, you did not release the fourth quarter because the rules have changed. And now that the rules—now everyone is playing under the same set of rules and you feel pretty confident this is the definite, that this is the set of rules that everyone would have to play under. And based on that, they passed.

Mr. FALCON. Yes, Congressman.

Mr. FORD. Let me ask you this, what more do you need to do your job better, do you think, if anything?

Mr. FALCON. I appreciate that.

Mr. FORD. Let's be honest, that is why we are here. I am just wondering what more do you think you need, if anything?

Mr. FALCON. I appreciate that. Now that the agency has moved forward, we have got the risk-based capital rule done, I am moving to try to strengthen the agency for the long term. And we have got several items we would like to undertake.

We would like to double the size of our examination staff. They are very talented and capable. But there are new challenges for them to meet. And to do so, they need to do their job with greater depth and with more resources.

We need to continue to enhance our analytical resources so that we can utilize the stress test not just as a capital standard, but also as an analytical tool to help us do our probing for weaknesses and vulnerabilities. And then that work, in turn, goes towards our examination staff to our research staff to do their work.

So I think all that comes down to additional resources for the agency. And the only sure way for us to do some long-term planning is for us to be permanently funded, as are every other safety and soundness regulator. And I think that is especially critical to the long-term success of the agency now that we have come this far in the first nine years.

Mr. FORD. Let me ask you this just taking you back, do you believe you have been as—I know the chairman had some questions about documents and materials, the request that has been fur-

nished in a timely way. Do you feel that you have complied with the law in terms of furnishing this committee with everything we have asked for—or members of this committee or, for that matter, the Congress—what they have asked for?

Mr. FALCON. Yes, Congressman. We supplied the committee with all the information it has requested. In fact, our schedule was to try to get the information to the committee by the end of July. Given the fact that the hearing is taking place on the 23rd, we had to re-double our efforts and work evenings and weekends to make sure that we could meet the chairman's deadline, which we have.

Mr. FORD. Do you feel like you will be able to meet that deadline now that we have got these new rules and everybody is fine?

Mr. FALCON. Yes. We supplied the chairman with the information yesterday—the last part of it.

Mr. FORD. My last question may be outside of your realm and you may not want to comment on it, but do you think it is a good thing that Fannie and Freddie decided to expense these stock options since, obviously, part of what we are feeling here, in the Congress, is the need to respond to the accounting scandals and the corporate fraud that—it is not as pervasive as the headlines suggest, but clearly has served to rock the markets in negative ways?

Do you believe that their efforts to do these things are positives—if you can answer that question, if you feel comfortable in your capacity answering that question as a witness representing OFHEO this afternoon?

Mr. FALCON. Sure. I think it is a very positive step by the enterprises. I think it represents their desire to maintain best-in-class standards of management at the enterprises. So I think it is a positive step. I certainly support the step they have taken today.

Mr. FORD. The zeal with which we do some of these, Mr. Chairman, I do also hope that we—the Congress, here, will act to get this corporate accounting—this corporate governance bill real soon and we will also even ensure that the SEC has what it needs. I would imagine that would be helpful in some ways to our witness today.

With that, I yield back the balance of my time, Mr. Chairman.

Mr. BAKER. Thank you, Mr. Ford.

Mr. Lucas?

Mr. LUCAS OF OKLAHOMA. Mr. Chairman, I do not have any questions, but I would gladly yield my time to the chair.

Mr. BAKER. Well, I thank you for that courtesy.

Let me return to the point that a couple of members made. One, Mr. Bentsen talking about the construction of the rule, as modified, that there were no significant modifications of consequence, to which I certainly agree, from a material financial calculation to Mr. Ney's comment that the rule was built to withstand depression-like scenarios that no other financial institution must meet. I, perhaps, agree with that.

And I think we have established in my first exchange that changes were made independent of GSE influence, pre-amendment, post-amendment; that the changes were minor; and that you do not feel it appropriate to release the fourth quarter 2001 pre-amendment results because one, the GSEs were not managing to that

rule and secondly, it is somehow unfair to make that information available.

In your March 21 response to me, you went on at length, indicating that you would comply with my request for the four differing sets of standards, indicating a two date delivery promise, one early for the post-amendment test analysis, one later for the pre-amendment analysis, but in no manner or measure did you indicate to me in that letter of March 21 that that data should be treated as confidential.

Secondly, in light of the 1999 data—why don't you move that? Nobody can see that. It is like being in the bleachers at Tiger Stadium. Move that thing over here somewhere.

Watch yourself, now.

[Laughter.]

We are going to move it over here a little closer. But you can go ahead and put the other one up. But move the whole thing over.

The 1999 data shows that Fannie Mae was not adequately capitalized for the purposes of the stress test. Now—

That is fine. Just tell him to come on in closer. I still cannot see it. Come down over here, behind this row of chairs right in front and kind of turn it toward the director so he can see, as well as members.

That is good right there.

I do not know if that is close enough or not.

Mr. BENTSEN. Everybody on this panel, except Mr. Ford, is over 30 and so most of us cannot see that well.

Mr. BAKER. Yes. We are going to need binoculars. We may need interpreters to understand it, too.

[Laughter.]

Now, this is the long-awaited challenge, not-to-be-released data, which is historic in nature. And I want my two colleagues who remain to be comfortable with this.

There is nothing in the data that pre-judges current operating condition or in any way impugns current management or in any way says that either Fannie and Freddie are not properly managed. But let's put this in its context.

They were operating in the last quarter of 2001, which was a very volatile financial marketplace. And the eight-and-a-half year test was then applied to the two enterprises.

What this says is that Fannie missed the mark by $600 million, whereas if you use the post-amendment test, they were in excess of the requirement by $2.4 billion.

Is that correct?

Mr. FALCON. Billion.

Mr. BAKER. Billion.

So it is a $3 billion swing from one test to the other.

Now, we have all heard that it was—the modifications were made without GSE influence. The modifications were minor. They are of no market consequence.

My view of the GSEs does not change as a result of this analysis. My evaluation is changing with regard to the agency. That is my point.

And now whether or not the enterprise was in any financial duress or not is only something probably the GSE knows. But if the

modifications to this test were made as a result of staff determination as to de-bugging—as to haircuts, as to multi-housing, as to funding costs and it results in a $3 billion swing, you have got to ask one of two questions. Is the test valid? Or were the changes made as a result of some political involvement in the management of the structure of this test?

And that is where I am.

And now I am not going to ask the director any more questions on that point because you have made your case quite clear. You have established the test based on what you believe to be the most valid professional standards. You subsequently had staff modify the test, based on what you believe to be professional standards. And you stand by the test.

Now let's go back to the fourth quarter of 2002 and Mr. Ney's comments. And I would certainly reserve time for Mr. Ney to come back and speak if he chose.

But he said the rule was built to depression-like standards of conduct.

Last quarter 2001 was a volatile financial quarter, but it was not depression-like in its nature. There was nothing that changes in the business structure of Fannie from the last quarter of 2001 to the first quarter of 2002 that makes any structural difference.

I am just having a really difficult time in understanding how that test applied to Fannie Mae in the last quarter of 2001 could result in the analysis we get and the new test applied to the same quarter results in a $2.4 billion capital surplus.

It does not make sense.

Jump in, Mr. Director.

Mr. FALCON. Sure. I would like to, Mr. Chairman.

First with respect to your point about me not asking in I think the March letter that the information be confidential, your letter to me requesting the information did not indicate that you intended to make the information public, so I did not feel any need at that point—

Mr. BAKER. Any time a member of Congress asks you anything, you have got to assume there is a press conference in the offing. I mean, you have been around here long enough.

[Laughter.]

Mr. FALCON. I know, Mr. Chairman, that—

Mr. BAKER. And let me say this, not to be frivolous, we debated this a long time. From your first announcement that you wanted us to keep this confidential, it caused me great angst. But we have gone through all the public records documents for you, everything we can come up with to determine whether it was or is not appropriate, and, basically, it was your request to me and that was it.

It is a public document, as a result of a government agency work product, provided to a member of Congress that has been shared with another member of Congress. So there is no question about it.

So let's move on beyond the debate of whether we should or we should not. The more important thing is about the facts.

Mr. FALCON. Right. And to that point, my request is certainly not binding on the subcommittee, Mr. Chairman, all I can do is make the request. And certainly it is—

Mr. BAKER. But historical analysis is not going to make any difference to the market.

Mr. FALCON. Let me address the issue of this chart here, please, Mr. Chairman.

First off, this does not—this is not all the information. If we are going to put this information out in the public, I think, so that this is not taken out of context, this should be put in place with everything else that I sent you.

Now, what the stress test shows for Freddie Mac, I am not sure if that is going to be released by the subcommittee, as well, but there is essentially little change in the numbers for Freddie Mac.

Mr. BAKER. I would be happy to discuss that and I want to know why the discrepancy.

Mr. FALCON. Well, Mr. Chairman, with respect to this data, itself, if you are suggesting that we made any changes to the risk-based capital to try to effect the outcome for the enterprise in the fourth quarter, I think that is just incorrect.

First, we did not have any fourth quarter information before us when we made decisions about how to modify the stress test. So there is no way that we could have tried to gauge the stress test to try to make them pass.

And secondly, we had no idea of knowing which scenario would be binding—the up or the down scenario—

Mr. BAKER. Well, let me ask you on that point, if you did not have fourth quarter, that does not really matter. You could run the test on any quarter and I suspect—

Mr. FALCON. You cannot run the test on any quarter, Mr. Chairman, each—that requires an extensive amount of data for each quarter. The enterprises have to assemble vast amounts of data, millions of points of data, parts of information are collected and are aggregated to create what we call a risk-based capital report—

Mr. BAKER. That would lead me to ask this question, are you then telling me that you did not run the test at all before you released it to the GSEs? You just said, "Here is the test, figure it out."

Mr. FALCON. We had some idea, based on our understanding of how the risk-based capital worked, about what might be some general—how the capital standard might be impacted by modification of the risk-based capital rule. And at the time that we published the final rule on this risk-based capital amendment, we said in the amendment that our anticipation is that the effects of this will be minimal and, in essence, a wash.

Now what you do not have up here is the up rate for Fannie Mae.

Mr. BAKER. I am sorry, the what for Fannie Mae?

Mr. FALCON. The up rate; this is just the down rate scenario for Fannie Mae. You do not have the up rate here, which shows that we actually increased our capital requirement by $5 billion.

Now, here you are saying that we decreased it by $3 billion, well we did not know which scenario would be binding. We did not even have this information in front of us. so we could just as easily have increased our capital requirement by $5 billion.

Now you are suggesting we intentionally decreased it by $3 billion; that is not true.

Mr. BAKER. So you are telling me if you took the fourth quarter of 2001 and ran the post-amendment test and took the same data and ran the pre-amendment test, that the differences between the two conclusions are what—minimal, not important, not clear?

Mr. FALCON. I am not sure how they are relevant.

Mr. BAKER. The same data, the same quarter, two different tests, one gives one result, the other gives another. They are relevant. There were modifications made to the test that caused the results to be different.

Mr. FALCON. Oh, absolutely. I agree with that.

Now, did we know what the results of the modifications would be? As I said, the fourth quarter was not even closed yet when I made these decisions on what modifications to make to the stress tests. So to suggest that we were results-oriented in making these changes, it is just not correct.

Mr. BAKER. Mr. Lucas has expired his time.

Mr. Bentsen, we come back to your side.

Mr. Shays?

Mr. SHAYS. I am happy to listen to questions or ask them. Which do you want me to do?

Mr. BAKER. Take off.

Mr. SHAYS. Okay.

I have already welcomed you, so I will not do that again. But it is good to have you here.

And I would like to ask, you know, on April 8, OFHEO announced it would conduct a comprehensive review of the financial disclosure policies and practices of Fannie Mae and Freddie Mac. Can you advise this committee whether OFHEO was still pursuing this review? And when can we expect its release?

Mr. FALCON. Yes. Thank you, Congressman.

We are still pursuing the review with the SEC and the Treasury. And we are expecting to try to complete it by the end of the year.

Now, that is our goal. We are going to use our best efforts to see if we can meet that goal. But we will see; maybe we will try to give you a mid-term report about how it is going.

Mr. SHAYS. When you say join it with the SEC and Treasury, who is doing the bulk of the work?

Mr. FALCON. That has not been established yet, Congressman. I imagine—

Mr. SHAYS. Is the work being done now? Or is it still not—

Mr. FALCON. Oh, yes, the work is currently being done. We are—

Mr. SHAYS. Okay. So who is doing most of the work so far?

Mr. FALCON. Well, we are doing a lot of research on the various types of mortgage-backed securities that are out there, the differential types of information that is released, along with each type of mortgage-backed security. And that will form the basis for us to undertake a comparison of the type of disclosures by issuer.

Mr. SHAYS. Can you explain to me why OFHEO has been charged with promulgating a rule that will facilitate the implementation of Fannie Mae and Freddie Mac's agreement to register and disclose to another agency the SEC?

Mr. FALCON. As part of this arrangement where the enterprises will voluntarily register under the 1934 act, OFHEO still maintains its safety and soundness authority. And it is not in any way

limited by this functional regulation, you could call it, of Fannie Mae's and Freddie Mac's security disclosures.

In so doing, we will promulgate a rule to require that these disclosures that are filed with the SEC also get filed concurrently with OFHEO. And there are two sections in the 1934 act, Sections 14 and 16, dealing with insider trades and proxies which, because of the operation of some of the language in those sections, it is necessary for OFHEO to promulgate a rule requiring the application of those sections to Fannie and Freddie. And then, in order to comply with our rule on those two sections, all they have to do is submit the reports to the SEC.

Mr. SHAYS. Is it unusual for one agency to basically, in essence, write the rule for another agency?

Mr. FALCON. That is not what we will be doing, Congressman. They would be required to submit, well, for the balance, for every part of the 1934 act, except these two sections, they are voluntarily submitting themselves to the jurisdiction of the SEC for purposes of the 1934 act. And so we are not going to facilitate that implementation.

But there are two sections for which require a little bit of a special treatment. And we are not going to promulgate a rule that in any way delegates OFHEO's safety and soundness authority. In fact, we will require compliance with Sections 14 and 16 and compliance would be through OFHEO. However, they would be able to satisfy our regulatory requirement by submitting reports to the SEC.

Mr. SHAYS. When do you expect the rule making to be completed?

Mr. FALCON. I am hoping we can get that done in just a couple of months, Congressman.

Mr. SHAYS. So by October 1 do you expect to have it done?

Mr. FALCON. We will try—October 1.

Mr. SHAYS. Do you expect it to be open for public comment?

Mr. FALCON. Absolutely, Congressman.

Mr. SHAYS. And when is the latest it would likely to take effect?

Mr. FALCON. I think, depending on what else is in there, we may—that will affect length of the comment period. As I said in my testimony, we may include in this rule additional disclosures, supplements of those that would be required in the 1934 act. And if we do so, we will want to be sure to allow sufficient time for notice and comment.

It could be anywhere from 30 to 60 or 90 days.

Mr. SHAYS. What role did OFHEO play in arranging the agreement between the SEC and the two GSEs?

Mr. FALCON. We worked with the SEC and the Treasury to make sure that this could and would work. Once we were all satisfied that this would work, we then went about just making sure that we had a meeting of minds between the three of us about how this would work.

Mr. SHAYS. And what role will OFHEO continue to play to ensure the agreement has teeth?

Mr. FALCON. We will require that the reports they file with the SEC also get filed with OFHEO. Our safety and soundness author-

ity and responsibility is not, in any way, limited by the enterprises voluntary registration under the 1934 act.

So we will continue to review them pursuant to our safety and soundness authority and review those reports, as well. And should we ever see any shortcomings, we would consult with the SEC about that.

Mr. SHAYS. Last week, Fannie Mae's quarterly analyst, Tim Howard, the company's CFO stated, "We sought and obtained written concurrence from the SEC that voluntary registration under the 1934 act would not change the fact that, among other things, securities issued or guaranteed by Fannie Mae are exempt securities under the Securities Act of 1933 and may be sold without registration under that act."

Is Fannie Mae trying to have it both ways by assuring the administration and Congress that it will submit to the government regulation and assuring Wall Street that it will remain exempt from government regulation?

And let me just ask this, is this an attempt by the company to perpetuate its implicit government guarantee? What is your opinion?

Mr. FALCON. Well, what I think the statement is in reference to is, it is a statement that the waiver of their exempt status under the 1934 act does not mean that they are waiving their exemption under the 1933 act. I think that is what the statement was going towards.

Mr. SHAYS. Have you seen this written concurrence? If so, will it be released to the public?

Mr. FALCON. I am not sure what the written concurrence is, Mr. Chairman. And I am not sure I have seen it.

Mr. SHAYS. Okay.

Mr. Chairman, are we aware of what if there is anything in writing?

Mr. BAKER. I am not.

Mr. SHAYS. Okay.

You know, I would just make a request that we get access to that.

I know my red light is on and so I will come back for a second round. But I do want to acknowledge that in the questions that we had asked before—and maybe this was pointed out—it was basically—maybe in your statement as well—I am happy that Fannie Mae and Freddie Mac will have to restate earnings. And they wanted our office to know that they were going to do that on August 14. And when we asked the Treasury, they did not know, but evidently that is going to happen. And I think that is a positive thing.

Mr. BAKER. Thank you, Mr. Shays.

Mr. Bentsen?

Mr. BENTSEN. Thank you, Mr. Chairman.

And Mr. Shays, I might recommend to you that in the testimony, Mr. Falcon's testimony on page six in the—I do not know if it is the carryover—you know, it is the first paragraph—in the fourth line it states that the ultimate arbiter of what must be disclosed will be the SEC and OFHEO.

The testimony goes into great detail about what OFHEO is doing. I think they are to be commended for that because they are the congressionally mandated regulator for safety and soundness over the GSEs. And, in fact, they seem to be working arm-in-arm with the SEC on trying to figure out how to merge the financials for purposes of disclosure—

[Laughter.]

Mr. BENTSEN. Our witness, I think, is very capable. So it is—but he was on this side of the aisle before. And he is a Texan, also, Mr. Shays, which is probably the main reason.

I want to go back to the line of questioning that the chairman had on the comparison of enterprise capital requirements, pre and post final rule amendment.

Let me restate, again, the rule went through the normal procedure. It went through the comment period. In fact, maybe even more so than normal procedure. You came and testified before this panel. You may have testified before a panel of the other body, I do not know. And had all the hoops you have to jump through with which to promulgate a rule under the laws of the United States, right?

And so the rule is the final rule and that is what you are required by law, to calculate the risk-based capital and minimum capital standards of the GSEs, right?

Mr. FALCON. Absolutely—that is right, Congressman.

Mr. BENTSEN. Now, Mr. Baker raises the concern—the broad variation in the fourth quarter Fannie Mae and first quarter—fourth quarter 2001 and first quarter 2002 Fannie Mae numbers as opposed to Freddie Mac. And I appreciate your concern of laying out unfinished work in a volatile marketplace and saying, "Well, gee, if you looked at it this way, even though that is not what the rule says, but if you made these assumptions for whatever reason, things might look worse than they really are—"

Mr. BAKER. Would the gentleman yield just a minute?

Mr. BENTSEN. I may have to yield.

Mr. BAKER. Just to clarify, the pre-amendment test was also promulgated. It was not a hip-pocket version that was short-circuited and then later saved by 60-day amendment process. It was an eight-and-a-half year product which was subsequently amended by a 60-day process. Just for the sake of understanding.

Mr. BENTSEN. Fair enough. But nonetheless, all following the APA and the enacting legislation. But nonetheless, back to my point, I understand your concern about saying, you know, putting out supplemental data, which, at least legally, and perhaps mathematically maybe has minimal value, but in a volatile marketplace could have substantial effect.

The changes in the amendment were primarily the haircut rules for derivative products and which would have affected the amount of capital or the amount of derivatives that the amount of capital set aside for purposes of the haircuts or the amount of derivatives that might be used for hedging purposes, and thus, the amount of capital that could be put at risk.

And I guess it affected the service, the ratings of the servicers and the amount of capital that might have to be set aside to account for those ratings.

And I assume there were some other technical changes.

Are you able to tell us, you know, since we have now delved into these numbers, perhaps more than we should, are you able to tell us what were the main reasons for the changes in the final numbers? Was it the haircut rule? Was it the servicing rating rules?

Mr. FALCON. It was based on additional information. We ground this rule very much in data and research and analysis and try to assess the risk of the various activities of the enterprises, based on our knowledge of how mortgages perform historically, based on differing loan characteristics, for instance. And as we get additional information to better understand various risks of the enterprises, we will undertake to make modifications to the stress tests.

And so this will be a dynamic stress test.

If a year or two from now we have more information which allows us to fine tune this even better, we may come out with an additional amendment. The idea is to continue to refine this.

We put out version 1.0 of this stress test. We will work towards version 2.0 and 3.0 over time.

I think part of the difficulty for the agency in trying to get this stress test done was trying to come out with version 5.0 at the beginning. So what we have got is a very robust, strong stress test.

Mr. BENTSEN. If I might, with the chairman's indulgence, the new information, is that information applied uniformly to both GSEs? Or is it information that is specific to one portfolio or another?

Mr. FALCON. It is information that is general information; it might be data, combined enterprise data. It might be research produced by either OFHEO or by some other third party about the performance of mortgages as a better estimation of counter parties.

It does not necessarily have to be enterprise specific data or analysis. In fact, it usually is not.

Mr. BENTSEN. I yield back.

Mr. BAKER. Thank you, Mr. Bentsen.

Mr. BENTSEN. Thank you.

Mr. BAKER. I am going to go to Mr. Shays. He has schedule constraints.

Mr. Shays?

Mr. SHAYS. Thank you very much.

Thank you, Mr. Chairman, for yielding to me.

And I would like to turn our attention to mortgage-backed securities and have you share with us whether Fannie Mae and Freddie Mac should continue to enjoy an exemption from disclosure in what is their mortgage pools. You know these two companies better than just about anyone. So I am particularly interested in your views on this issue. And are you comfortable with the continued exemption?

Mr. FALCON. Mr. Chairman, I think rather than give any opinions at this point, that is, I want to have the best possible information in front of me before I form judgments like that. That is why we are undertaking this study with the SEC and the Treasury.

Mr. SHAYS. Do you have a lean one way or the other?

Mr. FALCON. I cannot say right now, Congressman, because I have not reviewed the information that is put out by non-GSE issuers of mortgage-backed securities. So I would want to first compare what they put out versus what the enterprises put out.

Mr. SHAYS. But it is true that Wells Fargo, for instance, would have to disclose when they put together a pool. So I mean, it is just not some kind of strange activity for the business to have to do, correct? I mean, we have certain parallels that we can look at, correct?

Mr. FALCON. Right. Any issuer of debt, just by virtue of what the market will demand, will put out some level of disclosure that a companies that debt. That is your—

Mr. SHAYS. Last week, Treasury Undersecretary Peter Fisher testified, quote, "The time has come for Fannie and Freddie's investors to be assured that the level and quality of the corporate disclosure they receive are the same as those that are made by any other company that actively participates in our capital markets."

In your own testimony, you stated that OFHEO is, quote, "prepared to issue a rule requiring disclosure that would be, at a minimum, comparable to those of other trading companies", end of quote.

I do not quite understand this. How can we profess to want to treat Fannie and Freddie like any other publicly traded company and then qualify these statements by talking of continuing their exemptions from one of the two major security disclosure laws?

Mr. FALCON. I think that is—what is important here is the disclosure. The benefit you get with registration is the disclosure. And what we are trying to do with this study is ensure that there is a level playing field and adequate information that accompanies the issuance of mortgage-backed securities.

If we can, as I said in my testimony, if we can accomplish that, and I am very confident that we can establish adequate information, as well as the level playing field, through the cooperation and the joint study by ourselves and the SEC and Treasury, then registration is unnecessary. I am confident that we can get there with the right disclosure rules.

Mr. SHAYS. Isn't basically registration and disclosure somewhat parallel?

Mr. FALCON. I think that is right.

Mr. SHAYS. Yes. So the question is do you stand by your statement that OFHEO is prepared to issue a rule requiring disclosures that will be, at a minimum, comparable to those of other trading companies?

Mr. FALCON. Which—are you reading from my testimony, Mr. Chairman?

Mr. SHAYS. Yes.

Mr. FALCON. I think what I said—that at—prior to the enterprises' voluntary registration under the 1934 Act, we were prepared to issue a rule which would place them under requirements similar to the securities laws.

But since they have voluntarily submitted themselves under the 1934 act, we are not going to pursue a registration regime at this time. And the issue, with respect to the application of the 1933 Act and disclosures on their mortgage-backed securities—focus there will be on the adequacy of disclosures and the level playing field.

Mr. SHAYS. Mr. Fisher made it very clear to us that he certainly encouraged Fannie and Freddie to be under the 1934 Act. And I

am interested to know, did you play that same kind of role? Or were you passive on this?

Mr. FALCON. We were certainly supportive of the enterprises coming under a mandatory disclosure regime. And if it was not going to be under 1934 Act, then OFHEO was prepared to issue such a regulation. And I said so in response to an OMB prompt letter on the subject, as well.

Mr. SHAYS. Okay.

Can you explain—and I am pursuing this a little more deeply—can you explain why Fannie and Freddie will continue to enjoy an exemption from registering their MBSs? I would like for you to answer this question keeping in mind that companies in the jumbo market, in which Fannie and Freddie do not participate, are required to register their mortgage-backed securities. What makes Fannie and Freddie's mortgage-backed securities different, for instance, than the mortgage-backed securities, again, of Wells Fargo?

Mr. FALCON. I am not sure I can answer, Congressman, that is a judgment that Congress has made. And I would just defer to Congress' rationale for doing that when it granted the enterprises that exemption.

Mr. SHAYS. You that—you are on a little bit dangerous ground only because that would imply that you do not have opinions that you would present to Congress. Do you not ever have an opinion or a suggestion that you would make to Congress?

Mr. FALCON. No, Congressman. It is just in this area where we are studying the adequacy and the comparability of mortgage-backed security disclosures—it is just in this area where I am trying to approach this with an open mind and not pre-judging the issues as we go forward with that study.

Mr. SHAYS. Just one other, may I, Mr. Chairman, just pursue one other short line of questions?

Regarding the interagency review of mortgage-backed securities that will be conducted by SEC and OFHEO and the Treasury, can you tell me whether this study will examine both disclosure and registration of mortgage-backed securities? If not, why not?

And I will put this question out on the floor, too, just so—will the study investigate allegations that Fannie and Freddie cherry-picked the mortgage-backed securities, leaving lower quality mortgage pools for investors?

By the way, I want to say that Fannie Mae and Freddie Mac say this does not happen. And I am just suggesting that there is a question of whether it does or not and want to know if cherry-picking will be one of the issues you look at in your review.

Mr. FALCON. I think that is certainly an issue we will give some review, Congressman.

Mr. SHAYS. Okay.

Thank you, Mr. Chairman, for your patience and for yielding to me.

Mr. BAKER. Thank you, Mr. Shays.

Mr. Ford, please?

Mr. FORD. Thank you, Mr. Chairman.

This has become somewhat humorous, Director. We are glad you are here, but we are debating something up here and you are just caught in the middle of this thing. so we apologize for you having

to answer things that sometimes you feel uncomfortable and maybe even inappropriate.

But I am going to try to ask you something that I think is appropriate. And, obviously, I am a little biased about it.

But if you would not mind, forgive me, to compare and contrast the regulatory regime for Fannie Mae and Freddie Mac as it relates to safety and soundness. I imagine that you do not necessarily—at least not in this life you are not crafting things for these private enterprises, but if you would not mind giving us a sense, if you have a knowledge of that—if you could speak to that, I would appreciate that.

Mr. FALCON. Sure. Our regulatory program, Congressman, is very much identical to the type of regulatory program that banks have. We have very talented and skilled examination program, much like the bank regulators. We have a regulatory infrastructure which sets standards and expectations that we have for the enterprises, along with other informal types of standards, guidances, agency interpretations.

We have an active research group which helps us understand developments in the marketplace and the changing risk profiles of the enterprises. You know, we have talented financial analysts that can look at the enterprises balance sheets and results from the stress tests and try to help us better understand their vulnerabilities.

So our program is very comparable to that of any other bank regulator.

Mr. FORD. As it relates to—and this is a similar question, I am just trying to get it all on the record here, but how would—under this risk-based capital standard, how would other companies, primarily private banks, fair under this thing? I am not asking you to grade my bank, or for that matter, any other bank, but just a sense, because, again, we are—Chris Shays is my good buddy and he is writing a lot of things, particularly campaign reform. Richard Baker and I are good friends. He 's writing is lot of things, too.

And I do hope the kinds of questions that we are asking Fannie and Freddie—I hope at some point we can also bring in these doggoned credit reporting agencies and ask them—put up some charts like that and explain how they misreport peoples' stuff and how they go about fixing it.

But since they are not here, in terms of risk-based capital centers, how do you—how would they fair, some of these other companies fair in comparison to how Fannie and Freddie fair?

Mr. FALCON. I could not say without having, you know, a broad range of financial information about those companies. We get very deeply into Fannie and Freddie's activities beyond just what they might release in—

Mr. FORD. Forgive me for asking you to go beyond, but just, even if you do not feel like answering it, do not answer it, I just thought I would just put it out there because I think it—

Mr. FALCON. It is a very rigorous stress test. It imposes very stressful economic conditions on their balance sheets. You know, it is not the type of stress test that any other financial company has to be able to withstand, as a capital standard.

It would, I think, pose a challenge to many institutions to try to survive this.

Mr. FORD. I would if it would be appropriate, the chairman knows a lot more about these issues than I do, but I would hope—and I will yield back my time—I would hope that maybe we can even add and not to put any of these institutions on the spot, including my own financial institutions.

But at the same time, if we are going to be as demanding on these two organizations as we are—for good reason—and hopefully what will come out of this hearing is a safer and sounder system, then we should probably ask some of these other companies to provide or furnish us with this same kind of data.

I do not know if you want to, necessarily, do it, Director, but if, indeed these tests are conducted. But I would ask the chairman if we could take a look or if he would consider doing it. I know I would support an effort to do that.

And with that, I yield back the balance of my time.

Mr. BAKER. Thank you, Mr. Ford.

I guess I can best express my situation this way, Mr. Falcon, after eight-and-a-half years, we had a test. We gave the test; one GSE passed; one GSE failed. Ninety days later, we have another test. Amazingly enough, both GSEs passed.

Imagine what our public school system would look like if we gave everybody in the class a test. And then 30 days later, we came back and gave them exactly the same test with prior announcement. I bet our test scores would go up.

Or if, before our children could go out to play in the afternoon, we asked them, "Did you clean up your room?" "Oh, yes, dad, sure. But could you come back about seven and check it out?"

That is my problem here. We have a test that was developed after eight-and-a-half years of very intense, very hard work with congressional oversight, people fighting to protect your budget, get you the staff you needed. And I feel, frankly, very let down. At the end of the day, we have got a process, by virtue of haircuts on mortgage insurance companies, multi-family housing treatment, funding costs and some technical stuff I do not understand that we find such an erratic swing in the financial adequacy in relation to the stress test of one GSE.

I have just got to tell you that I am not comforted either by the written or oral explanations of how we are where we are. Something has to be done about this.

Now, I am not faulting you, individually. I may be faulting the process. I may be faulting the structure of OFHEO. It is, after all, the only regulatory body in the financial world that is funded by congressional appropriation instead of fees on the regulated enterprises.

There may be other regulatory powers you need you do not have.

But I have just got to tell you, this is unacceptable that—I do not know where we go from here. But there has got to be another place to land that can give the taxpayer of this country an accurate honest assessment of the true risk exposure they face in the indirect support of two enterprises which have over $3 trillion of exposure to this economy. That is enormous.

And in light of the financial conditions of the market we face today, giving all the allegations that are floating—thank goodness we are not hearing any of that about Fannie or Freddie. I can only imagine the consequences if one of these two corporations were to report a financial irregularity.

I am not alleging today that either of the enterprises are mismanaged—that they are taking on risk that they should not take. But I do not know what the road holds ahead. I do not know if the current management is going to be there 10 years from now. I do not know that the tools OFHEO has are going to be adequate as the enterprises continue to grow and expand.

If we look back a decade and see what they looked like then and look at them today, there is a dramatic change in the risk profile of the two enterprises. One has a fairly significant amount of hedges in relation to the debt issued. The other one does not. Does that mean the other one is not appropriately managed? I do not think so.

But we need to have a better, clearer insight which leads to less debate.

I have not heard any explanation as to why the changes that were made—one, were made; two, as to how they could result in a $3 billion shift in the calculation resulting on the last quarter's calculations of 2001; and why I should be comforted in the manner in which the discussions have resulted in this foster.

And, again, I say this having been in the trenches with you and fought the appropriators for a long time to get you into the place where I felt like we had the resources to at least stand toe-to-toe with them.

I really do not have anything else to add. I just, over the August recess, I am going to give this a lot of thought—try to come back with something that is constructive. And I hope we can find a way to, once and for all, answer the questions that I know every taxpayer has got to want to know—am I safe? Given the volatility in the markets we face, we do not need this additional concern added into the financial calculus.

And I, please, want to afford you the opportunity to make any comments you wish.

Mr. FALCON. I appreciate that, Mr. Chairman. And you have always been the—supportive of OFHEO when we have needed it in our budgets. It often feels like a form of tough love that you have for the agency.

But it is, I think, you are well intentioned about trying to support the agency.

I would just suggest to you that the information that you put up here on the chart—I do not think it is an accurate demonstration of what we have done with this risk-based capital rule.

In addition, the reason I think this information is also somewhat misleading about the enterprises' financial condition and what we have done is that I announced early in the fourth quarter that we were not going to release fourth quarter data. Now, had the enterprises understood that I was going to release fourth quarter data, would they have done something differently? Well, I do not know.

Mr. BAKER. But on that point—let's take the issue—they did not know, so they were not managing to it. They were taking risks we

did not understand? Are you telling me we should not give pop quizzes? That we should drop in as a regulator—as an unannounced inspector of the credit files and see what is going on in the inner-enterprise? Are you telling me we have to give them a certified notice, "We have coming June 14, 2003. Get your lipstick and your hair done"? I mean, come on.

Mr. FALCON. It depends on what you want out of the capital standards. I do not use them as a game of "Gotcha."

Mr. BAKER. No, I do not either, but I want to know what real risk is involved in the real world and what we are taking on. And apparently—

Mr. FALCON. And I think this rule does that. You know, I would like to have an opportunity, going forward, to try to persuade you that we have promulgated a very robust and strong risk-based capital rule. And we will be glad to give you a more in-depth explanation about the changes we have made.

They are certainly well explained in the final rule that implemented the modifications—

Mr. BAKER. Well, the only—last point is that let's assume for the moment I am wrong on every point and that there is no merit to any of the criticisms I have leveled here today—why are we waiting until the first quarter of 2003 to implement the rule—to make it enforceable?

Mr. FALCON. That is what the statute provides, Mr. Chairman. The statute says that this shall not be enforceable until one year after it is effective. That is what the statute says.

Mr. BAKER. One year from September 2002 or—

Mr. FALCON. One year from September 2001.

Mr. BAKER. So that would be September 2002?

Mr. FALCON. Yes.

Mr. BAKER. So why are we waiting until the first quarter of 2003?

Mr. FALCON. We are not. this rule will be—

Mr. BAKER. Well, that is good news. I was under the impression you were not going to have it enforceable in 2003.

Regardless, I am saying to you that there is significant problems with the structure we now have. We need to make some modifications. We have got the August recess to see if we can figure out some solutions.

I look forward to talking to you.

Unless Mr. Bentsen—yes—well, please, Mr. Bentsen?

Mr. BENTSEN. Thank you, Mr. Chairman.

And, again, let me thank you for calling this hearing. And even when we do not agree, I appreciate the amount of time and effort you put into this.

I think, though, we need to make clear that there may be two issues here. One may be a process issue, although I would argue that we followed the—you know, we have been going through this with the APA. We had a hearing before this committee. Members of this committee on both sides of the aisle raised concerns about the proposed final rule. Amendments were made under the APA. And that is the final rule.

And so on the one hand, we can raise concerns about the process. And they are legitimate. But on the other hand—and on any rule-

making procedure. On the other hand, the question really has to be are you satisfied with the formula for the risk-base analysis and the minimum capital analysis? And if you are satisfied, then it is what it is. And if you are not satisfied, then that is another matter to look at.

Perhaps the committee ought to take a look at whether or not we think, after all this work and the eight—10 years that the staff and analysts have been looking at this—whether or not the math is right or not, but the math is what it is.

And we have to live with that and then in September they will begin to classify. And you have to pick markers in time with which they meet.

I agree with you that—I mean, as I understand the laws and the way it works, OFHEO is in the GSEs. They are, as in many respects, the same way that bank examiners are in the bank. But they have to look at quarterly mileposts as they go through this to determine where they are in terms of capital.

But, again, it is gone through the APA and maybe our debate has to come down to we do not like what you finally came up with. But you put a lot of time into it and we have not heard a lot of people come back and say, "We think your formulas are wrong."

And maybe that is what they need to do, but they have not done it yet.

Mr. BAKER. And I would suspect that there are not a lot of people in the world who sit around their breakfast table in the morning discussing the stress test adequacy of the government-sponsored enterprises.

Mr. BENTSEN. Only in Baton Rouge, I think.

Mr. BAKER. I can assure you when I get home I turn into a real person.

Let me express this perspective, just to keep it in its proper context. When I wrote the letter to Mr. Falcon asking for the four permutations of the test, I really had no anticipation—nobody could have—as to exactly what the consequences. Because Mr. Falcon has testified that he did not know what the results of the test would be. It took considerable effort and time to run the test.

I was kind of hoping that they would all come out within margin of error of each other and we could go on about our business. But I thought it would be a great thing for this committee to have, as a platform for future analysis, the four tests on two quarters run and we could then judge future test results by that platform.

And I had a hint, when it took so long to get number four, that there was something up. But I had no substantive knowledge that the end result of that last test would be to show a GSE insufficient in relation to the test standard.

That really was it.

But now that it has occurred and I am trying to understand why and how, I am not at all happy with the consequences or the explanation as to how we got where we are. Because a $3 billion swing, even in GSE light world, is a significant swing.

So for the record, I appreciate the long-standing effort.

I appreciate, certainly, the gentleman's work from Texas in sitting through these hearings. You have been one of the few who has been able to make it through all of these.

I am sincere in my concerns. I do not feel I know today any more about the true financial picture of the GSEs than I did five years ago. And after time, money and effort spent in this effort, that is, I think, rather disappointing.

So I thank the gentleman for his testimony, his willingness to be here today. I am confident the release of this data has no consequence to the market performance whatsoever.

And I look forward to working with the members of the committee on resolution of these matters in the coming months.

Meeting adjourned.

[Whereupon, at 3:53 p.m., the subcommittee was adjourned.]

A P P E N D I X

July 23, 2002

Opening Statement of Rep. Bob Barr
Subcommittee on Financial Institutions Legislative Hearing on
H.R. 3424, "Community Choice in Real Estate Act"

July 24, 2002

Mr. Chairman. Thank you for scheduling this hearing on H.R. 3424, a measure which I strongly support and am pleased to cosponsor.

Over the last two centuries, Congress has repeatedly and explicitly prohibited financial institutions from engaging in commercial activity. The National Bank Act of 1864 prohibited federally chartered banks from engaging in commercial activities.[1] This policy was strengthened during the Great Depression, when Congress moved to prohibit a single business entity from engaging in both commercial banking and investment banking businesses.[2] In 1956, the Bank Holding Company Act[3] limited the non-banking activities of multiple-bank holding companies and brought them under the control of the Federal Reserve Board, Subsequent legislative pronouncements have been clear and unequivocal, and are underpinned by an equally clear and immutable policy rationale: mixing baking and commerce would create market distortions that would unfairly benefit commercial banks, and introduce potentially devastating distortions into competitive commercial and financial markets.

As we all know, on January 3, 2001, that Federal Reserve Board and Treasury Department issued a proposed rule which would redefine financial activities to permit banks to compete in the real estate brokerage and management markets. H.R. 3424 would stop this proposed rule, and maintain the carefully balanced status quo set forth by Gramm-Leach-Bliley. Opponents of H.R. 3424 can point to no language in the Gramm-Leach-Bliley Act (GLBA) which delegates to federal agencies general authority to abrogate this fundamental and long-recognized principle. The text and legislative history of GLBA clearly demonstrates Congress intended the historic firewall between banking and commerce to be preserved, not destroyed. During congressional consideration of GLBA, Federal Reserve Board Chairman Alan Greenspan urged Congress to maintain the historic separation between commercial and financial activities. In testimony before this Committee, Chairman Greenspan stated:

> "As technology increasingly blurs the distinction among various financial products, it is already beginning to blur the distinctions between predominately commercial and banking firms...It seems to us wise to move first toward the integration of banking, insurance, and securities...and employ the lessons we learn from that important step before we consider whether and under what conditions it would be desirable to move to the second stage of full integration of commerce and banking. The Asian economic Crises last year highlight some of the risks

[1] 13 Stat. 99, 101, codified at 12 U.S.C. § 165 (2000)
[2] Glass-Steagall Act or The Banking Act of 1993, 89, 48 State. 162 (12 U.S.C. § 340-360, repealed).
[3] 70 Stat. 133, codified in scattered sections of 12 U.S.C. (2000).

> that can arise if relationships between banks are commercial firms are too close."[4]

Clearly, the advice of Chairman Greenspan was ignored by the Clinton Treasury Department, which noticed this proposed rule shortly after GLBA went into effect.

The Legislative history of GLBA further highlights the intent of Congress to place limits on the authority of the unelected of federal agencies to determine which activities are "financial in nature or incidental to financial activities." The Report states:

> "This authority includes authority to allow activities that are reasonably connected to one or more financial activities...[t]he authority provides the Board with some flexibility to accommodate the affiliation of depository institution with insurance companies, securities firms, and other financial service providers *while continuing to be attentive not to allow the general mixing of banking and commerce in contravention of the purposes of this Act.*[5]

Finally, former Chairman Jim Leach, a principal author of GLBA, stated:

> "Of all the things I am proud of in the modernization legislation, it is that our government's two principal financial bodies – the Treasury and the Fed stand with me against mixing commerce and banking. There should be no misunderstanding. If this precept had been included in the final legislative product, I would have done my best to pull the plug on financial modernization."[6]

The substantive merits of reversing the proposed rule are overwhelming, and the 245 cosponsors of H.R. 3424 clearly demonstrate the Treasury Department and the Federal Reserve are flouting the intent of Congress by proposing this rule. However, the grave flaws in this proposed rule are not confined to policy alone.

On May 16, 2002, the Judiciary Committee Subcommittee on Commercial and Administrative Law, which I chair, conducted a hearing on procedural and administrative aspects of the proposed rule. Specifically, the Subcommittee examined the following questions:

- Did the statute giving rise to the proposed rule provide sufficient congressional authority to transform the definition of "financial activity" without congressional consent?
- Was the language in GLBA sufficiently clear to provide a coherent basis upon which the respective agencies could make this determination?

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[4] Statement of Federal Reserve Chairman Alan Greenspan, Cong. Rec, S4626 (1997).
[5] S. Rep. No. 106-44, at 21 [available at http://thomas.loc.gov/cgi-bin/cpquery/R?cp106: FLD010:@1(sr044)].
[6] Press Release of Rep. Jim Leach, May 17, 2000.

- Can – *should* – Congress delegate its authority to regulate interstate commerce without any cognizable constraints on agency discretion?
- Did the issuing agencies provide a sufficient factual or legal basis for concluding that real estate brokerage and management are "financial activities?"
- Were the procedural requirements of the Administrative Procedure Act and the Regulatory Flexibility Act adequately observed?
- How will the agencies consider and act on the public comments they have received?
- How will the proposed rule affect consumer privacy?

During the course of the Subcommittee hearing, it became obvious the procedural bases on which the rule was issued were deeply flawed. Not only did the issuing agencies ignore the text and legislative history of GLBA, they totally disregarded relevant and applicable administrative procedures and precedents, but the overwhelming weight of public opinion against this rule as well.

Since the advent of the modern regulatory state, Congress and the President have continuously sought to craft an administrative process that treats all parties and all perspectives fairly. While we have striven to obtain the best possible agency rules, another, equally important purpose is to make the administrative process an open on that informs the American people about the actions of its government. The proposed rule does not advance this goal, it thwarts it. If finalized, the rule would substitute overwhelming public sentiment and the will of Congress with the arbitrary and capricious dictates of unelected agency bureaucrats.

The American people deserve better, and Congress has a responsibility to reverse this proposed rule by passing H.R. 3424. The last thing America needs is the additional financial uncertainty that finalization of this rule would invite. I wish again to thank the Chairman for scheduling a hearing on this important legislation and urge a speedy markup of this bill.

July 23, 2002

Opening Statement for Congressman Paul E. Gillmor
House Financial Services Committee Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Hearing
Hearing on OFHEO's Risk-based Capital Rule

I would like to thank Chairman Baker for holding this important hearing to allow this subcommittee to consider the risk-based capital rule finalized last March by the Office of Federal Housing Enterprise Oversight (OFEHO).

I am pleased to see Director Falcon before us today to provide further details on the minimum leverage capital requirement, capital classifications and the stress test to be used in determining the risk-based capital requirements for Fannie Mae and Freddie Mac, detailed in the recent rule-making.

I am particularly interested to hear specifics on the results of the first application of this risk-based capital stress test and OFHEO's subsequent report on the overall safety and soundness of Fannie Mae and Freddie Mac. In June, it was announced that both Government Sponsored Enterprises (GSEs) passed the initial test.

Given the recent decision by Fannie Mae and Freddie Mac to voluntarily begin filing their financial statements with the Securities and Exchange Commission (SEC), I look forward to learning the specifics of the Disclosure Review Process mandated by OFEHO and their relationship to SEC-required periodic reports. I also would like to hear Director Falcon's opinion on a recent legislative initiative that would mandate full SEC registration for both Fannie Mae and Freddie Mac.

Again, I would like to thank Chairman Baker for holding this hearing and Director Falcon for coming before us today. I look forward to an informative session.

Opening Statement
For
Congressman Rubén Hinojosa (TX-15)

Committee On Financial Services
Subcommittee on Financial Institutions and Consumer Credit
Hearing on H.R. 3424, Community Choice in Real Estate Act
July 24, 2002

Mr. Chairman and Mr. Ranking Member,

I want to thank you for calling this important hearing today on H.R. 3424, the Community Choice in Real Estate Act. This bill, introduced by my good friend and colleague, Congressman Ken Calvert, aims to clear up any confusion the banking and real estate industries might have in relation to the Gramm-Leach-Bliley Act.

While the GLB Act helped federally charted banks access many new services and industries in the financial market, I believe that it did not include real estate brokerage.

This legislation and this hearing gives us the opportunity reexamine whether or not these two industries should be allowed to merge or share in similar business enterprises. As a representative of a congressional district where minority and low-income home ownership are a top concern, I am especially interested in how the potential merger of these two industries will impact the Community Reinvestment Act, predatory and sub-prime lending, and low-income and first time home owner loan programs. Mr. Chairman, I hope the panelist will address these issues and I look forward to their remarks.

Mr. Chairman, once again thank you and I yield back my time.

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CAPITAL MARKETS, INSURANCE, AND GOVERNMENT-SPONSORED ENTERPRISES
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Congress of the United States
House of Representatives

STEVE ISRAEL
Second District, New York

Statement of Congressman Steve Israel
Hearing on the Office of Federal Housing Enterprise Oversight's Risk-Based Capital Rule
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
July 23, 2002, 2:00 p.m.

Mr. Chairman, thank you for holding this hearing today. I believe that strong oversight from the Subcommittee will only enhance our system and strengthen the GSE's.

The rule we are examining today is extremely important. It ensures that Fannie Mae and Freddie Mac have sufficient capital to withstand a worst-case economic scenario, one with high credit losses and substantial moves in interest rates over a 10-year period.

The rule is unique because it requires Fannie and Freddie to manage their businesses in a way that reduces risk. It requires the companies to either hold very high levels of capital or substantially reduce the risk they retain through such mechanisms as mortgage insurance and interest rate hedging. Importantly, it is a regulation unique to Fannie Mae and Freddie Mac; banks and thrifts are not required to meet such a test.

This is just one piece of a comprehensive regulatory regime for Fannie Mae and Freddie Mac. That regime includes continuous on-site examination, annual examination reports to Congress, minimum capital requirements and risk-based capital requirements. Fannie Mae and Freddie Mac are regulated by OFHEO for safety and soundness, HUD for their mission to provide affordable housing, Treasury for their Agency debt offerings, and just recently by the SEC for corporate disclosures.

These companies have voluntarily embraced a sense of transparency and corporate responsibility. More importantly, they live up to their missions to expand access to affordable housing. If you look across the country, they are in all of our districts, on Long Island, in Louisiana, everywhere. In my district, they have been instrumental in making sure struggling seniors are able to get access to a decent, affordable housing. Without their commitment, many of the underserved in my district would not be in homes.

Mr. Chairman, we have to make sure that as we oversee and regulate these companies, we keep our eye on their mission and allow them to focus on their core competency of creating affordable housing opportunities for all of our constituents.

Statement of Congressman Bob Ney
July 23, 2002

Thank you Mr. Chairman for holding this important hearing. I am pleased that the committee has a chance to review the final risk-based-capital rule for Fannie Mae and Freddie Mac. This capital standard has been a long time coming and we are grateful that the process has now concluded. We look forward to this rule being enforceable in the months ahead.

The risk-based capital is designed to ensure that the GSE's can survive the worst of housing downturns, with high credit losses and huge moves in interest rates over a ten-year period. This risk-based capital is unique, because it requires the GSE's to operate their businesses in a way that creates an incentive for risk reduction activities; it should be a model for all companies.

It is important for this subcommittee to realize that the risk-based capital standard is just one piece of an overall safety and soundness regime for these congressionally chartered companies. To be clear, after the 1992 legislation, both of these companies were bound by minimum capital standards and continuous "on-site" examinations. And, long before Enron and Worldcom, in October 2000, Fannie Mae and Freddie Mac announced six initiatives that the financial markets now rely upon to maximize financial transparency and market discipline.

Unlike any other company, these two companies have signed up for an annual credit rating, additional interest rate and credit risk disclosures, additional liquidity management, interim implementation of the risk-based capital standard, and the issuance of subordinated debt.

Less than two weeks ago, I joined SEC Chairman Harvey Pitt and Fannie Mae and Freddie Mac for an announcement where these two companies agreed to register their common stock under the 1934 SEC Act – which now binds these two companies to comply with SEC requirements for periodic corporate financial disclosures.

In the press interviews after the announcement, Frank Raines committed on CNBC that Fannie Mae **will** certify 2001 financial statements by mid-August, just as SEC Chairman Harvey Pitt has asked of the top 1,000 publicly traded companies.

In addition, I was pleased to hear this morning that both companies have announced they are recommending to their boards of directors that they begin expensing all stock-based compensation.

In the current economic environment, few other companies are stepping up to the plate to lead on financial disclosure and transparency they way that Freddie Mac and Fannie Mae are.

I look forward to hearing from Director Falcon, and I appreciate the hard work of this Subcommittee.

EMBARGOED FOR RELEASE UNTIL:
2:00 p.m. EST
Tuesday, July 23, 2002

TESTIMONY OF

ARMANDO FALCON, JR., DIRECTOR
OFFICE OF FEDERAL HOUSING
ENTERPRISE OVERSIGHT

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

2128 RAYBURN HOUSE OFFICE BUILDING

JULY 23, 2002

STATEMENT OF
THE HONORABLE ARMANDO FALCON, JR.
DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
BEFORE THE
SUBCOMMITEE ON CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES[1]

JULY 23, 2002

Mr. Chairman, Representative Kanjorski, and Members of the Subcommittee, I am pleased to testify before the Subcommittee today on the Office of Federal Housing Enterprise Oversight's (OFHEO) safety and soundness oversight of Fannie Mae and Freddie Mac (the Enterprises). In my testimony, I intend to discuss the specifics of the Agency's oversight of the Enterprises but first I would like to speak to the overall condition of the U.S. housing market and the Enterprises.

The U.S. Housing Market Continues to Flourish

The housing market has shown remarkable strength over the past 18 months, despite the September 11th attacks and recession. Low mortgage interest rates, averaging less than 7 percent, are largely responsible. Recent declines to 6.5 percent bode well for continued housing and mortgage market strength in the near term. Last year, housing starts exceeded 1.6 million units, and so far this year they are on pace for nearly 1.7 million units, the most in 16 years. Similarly, home sales in 2001 totaled 6.2 million units, the best year ever, and are running at more than 6.5 million this year.

Spurred by heavy refinancing activity, last year's originations of single-family mortgages doubled the previous year's level, topping the $2.1 trillion mark. This year's total likely will be lower, but second only to 2001. The expansion in home sales has translated into increased homeownership. The homeownership rate reached a record high of 68 percent last year.

Home values, stimulated by heavy demand, have continued their upward trend, albeit at more moderate rates. Single-family home prices, as measured by OFHEO's House Price Index (HPI), increased 6 percent from the first quarter of 2001 to the first quarter of 2002. During the previous 4 quarters, appreciation was 9.3 percent.

[1] The views expressed herein are my own and do not necessarily represent the views of the Secretary of Housing and Urban Development or the President. The Office of Federal Housing Enterprise Oversight (OFHEO) is an independent office within the Department of Housing and Urban Development (HUD) charged with ensuring the safety and soundness of Fannie Mae and Freddie Mac (the Enterprises).

The Enterprises' Financial Performance

Against the backdrop of a strong U.S. housing market, the Enterprises also had a very successful year in 2001, and a strong first half this year. Both Enterprises' mortgage purchase volumes and securitizations were at record levels last year. Favorable market conditions also stimulated growth in the Enterprises' mortgage asset portfolios. The combined assets of the Enterprises increased 25 percent in 2001. That portfolio growth, along with widening spreads between asset yields and debt yields, enhanced the Enterprises' operating earnings. This year, asset growth and the flow of new securitizations have moderated, but profits continue to benefit from very low short-term funding costs. Combined operating profits of the Enterprises for the 4 quarters ending March 31 were $9 billion, 23 percent higher than during the previous 4 quarters. Such income growth has enabled the Enterprises to continue their long histories of high rates of return on equity.

The Enterprises have continued to actively manage their exposure to credit risk. The proportion of single-family mortgages purchased that were evaluated using the Enterprises' automated underwriting systems prior to sale approached or exceeded 60 percent in 2001. The Enterprises have also continued to limit their exposure to mortgage credit risk by obtaining credit enhancements on higher-risk single-family loans. Credit losses – foreclosed property expenses plus net loan loss charge-offs – have remained very low at the Enterprises despite the growth in their owned and guaranteed mortgage portfolios and the generally weak economic conditions. Combined Enterprise credit-related losses were only $151 million on an exposure in excess of $3 trillion over the 4 quarters ending March 31.

Despite sizeable changes in interest rates last year and this year, the Enterprises have effectively managed their exposure to interest rate risk. This was accomplished by hedging asset acquisitions - - making substantial use of derivatives, rebalancing those hedges as interest rates changed, and continuing judicious risk management oversight.

Finally, OFHEO -- as required by its statute -- reported to Congress on June 15 the results and conclusions of its ongoing examination of the Enterprises for 2001. Those results and conclusions stated that the Enterprises were operating in a safe and sound manner. OFHEO's examination teams are on-site at the Enterprises continuously, evaluating their operations with assessment factors covering more than 160 features of safety and soundness.

OFHEO's Safety and Soundness Oversight

I'll now turn to the specifics of OFHEO's financial safety and soundness oversight of the Enterprises. Some like to talk about this form of oversight as having three pillars that help ensure the financial safety and soundness of the regulated entities at issue. These pillars, risk-based capital requirements, market discipline, and supervisory review, are used together to ensure the Enterprises operate in a safe and sound manner. I refer to them as legs on a stool and include research and analysis, which in many respects ties the

first three together. With risk-based capital requirements complete, the Agency is moving further ahead in other areas - - some of which you have specifically asked me to address today.

Risk-Based Capital Requirements

OFHEO's risk-based capital standard is unique among financial regulators. Unlike ratio-based capital rules, OFHEO's standard is based on a 10-year stress test. A stress test measures risk in the context of a company's overall portfolio, including the company's risk management activities.

OFHEO's stress test simulates an Enterprise's financial performance over a 10-year period under severe economic conditions. Key conditions describing the severe economic conditions used in the Agency's stress test are defined in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the '92 Act) and further specified in OFHEO's risk-based capital regulation. These conditions include high levels of mortgage defaults, with associated losses and large, sustained movements in interest rates. To meet OFHEO's risk-based capital standard, each Enterprise must have sufficient capital to survive the losses under these severe economic conditions plus an additional 30 percent for unspecified management and operations risks.

The stress test aligns the capital requirement for each Enterprise with its specific risk profile. In doing so, it provides Enterprise management with incentives to carefully manage risk. For example, risk reduction activities -- such as the effective use of interest rate derivatives -- work to lower the requirement. Conversely, activities that increase risk -- such as taking on unhedged interest rate exposures -- serve to increase the requirement.

An Enterprise's risk-based capital requirement is also sensitive to changing economic conditions that are beyond the control of management. For example, house price growth influences mortgage credit losses, and thus the requirement. Changes in interest rates also affect the risk-based calculation, e.g., such a change can effect mortgage prepayments and income generated from adjustable rate mortgages.

The dynamic nature of the stress test facilitates OFHEO's understanding of how changes in the economy could impact the Enterprises. It will also help OFHEO uncover changes in capital needs before there could be a significant impact on the Enterprises' balance sheets. In contrast, capital standards based on static ratios are affected only after economic changes impact the balance sheet.

OFHEO's stress test provides the Enterprises with transparency, certainty and flexibility in meeting their regulatory capital requirements. Both Enterprises have copies of OFHEO's stress test and have incorporated the test into their everyday business processes. An Enterprise can comply with OFHEO's risk-based capital standard by reducing risk or raising capital, or a combination of both. Therefore, each Enterprise can follow its own unique strategy to comply with the standard.

The risk-based capital rule became effective last September. At that time, I appeared before the Subcommittee and was urged to consider whether refinements to the rule were necessary and, if so, to act quickly. I subsequently determined that modifications were appropriate and the rule was amended after a public rulemaking during the fourth quarter of last year. We will use the rule to classify the Enterprises beginning with the third quarter of this year.

Per our enabling statute, the rule is not enforceable until September 13, 2002. OFHEO will not use the risk-based capital standard to classify the Enterprises for regulatory purposes until the end of the third quarter 2002. These results will be released in December. Starting then, an Enterprise will need to meet both its risk-based and minimum capital requirements (a more bank-like leverage based requirement) to be classified as adequately capitalized. Until then, it need only meet its minimum requirement.

In the interim, I made a determination -- in the interest of public disclosure and regulatory transparency -- to publicly release first quarter 2002 numbers. These are:

FANNIE MAE

As of March 31, 2002, Fannie Mae's risk-based capital requirement was $20.228 billion. Fannie Mae's total capital of $26.290 billion on that date exceeded the risk-based capital requirement by $6.062 billion. However, Fannie Mae's **higher** minimum capital requirement of $24.571 billion was binding.

FREDDIE MAC

As of March 31, 2002, Freddie Mac's risk-based capital requirement was $5.680 billion. Freddie Mac's total capital of $21.360 billion on that date exceeded the requirement by $15.680 billion. However, Freddie Mac's **higher** minimum capital requirement of $19.390 billion was binding.

With the proposal of the rule in 1999, the Enterprises began a program of managing their activities to ensure they would meet the requirements of the rule. Their prudent measures, combined with favorable economic conditions, have resulted in their passing the standard at this stage of the one-year implementation period. These results demonstrate how the test works with respect to the different companies. Freddie Mac's stress test results were especially strong because its hedges enabled it to maintain positive net interest income through nearly the full stress period in both interest rate scenarios. This points to nothing more than the fact that the two companies hedge interest rate risk differently.

Corporate Disclosure

I will now turn to corporate disclosure. OFHEO's safety and soundness responsibility includes an obligation to ensure that Enterprise financial disclosures are adequate. Our Agency began a comprehensive review of Enterprise disclosure in April 2002.

OMB requested that OFHEO specifically consider a rule as part of its action plan in May 2002; such a rule should contemplate the mandatory application by OFHEO of SEC rules to the Enterprises (similar to bank regulatory rules) along with additional disclosures that OFHEO felt would be appropriate. OFHEO has full authority as safety and soundness regulator to review this important topic and to undertake a range of supervisory actions.

In late June, I communicated to OMB the substantial progress the Agency had made in its review and responded to their May letter. Most significantly, I noted that our review had reached a point that it was clear to me that voluntary compliance was inadequate and that given their exemption from the securities laws, OFHEO needed to promulgate enforceable rules in this area. We are prepared to issue a rule requiring disclosures that would be, at a minimum, comparable to those of other publicly traded companies, further strengthen the safety and soundness of the Enterprises, and advance the President's 10-Point Plan for Corporate Responsibility.

I am pleased with recent developments in this area. The Enterprises' voluntary compliance with certain SEC registration act requirements is a significant move toward OFHEO's goal of assuring mandatory conformance with disclosure rules and assuring that the Enterprises maintain a "best practices" approach. OFHEO was pleased to participate in this initiative and will do its part to facilitate its implementation. Specifics of OFHEO's review, and the subsequent agreement, follow.

Specifics of the Disclosure Review Process

OFHEO reviewed Enterprise equivalents of SEC required periodic reports. They appear to have been produced pursuant to the requirements of SEC regulations, but we will defer to the SEC to determine if they officially meet the standards of disclosure demanded by the Commission.

Even if the voluntarily produced periodic report equivalents do meet SEC standards, however, a formal registration of the Enterprises should improve disclosures made to investors. I believe there are three very important reasons for this.

First, it will be **mandatory**. Today, the Enterprises voluntarily attempt to comply with SEC requirements for full and fair disclosure. With this agreement, they will be locked into such a program. Were it not for the voluntary agreement of the Enterprises to register with the SEC, OFHEO would have acted and adopted its own disclosure regime based on the securities acts.

Second, and most significant, the disclosures will be **reviewed** by the SEC for material adequacy. Currently, it is the Enterprises who determine whether and what corporate information is material and must be disclosed. Once registered, that will change and the ultimate arbiter of what must be disclosed will be the SEC and OFHEO. This will be the SEC in its review of the Form 10 registration statement and Enterprise periodic reports and OFHEO will determine if additional disclosures are required. Of course, registration under the Securities and Exchange Act of 1934 (The '34 Act) brings with it the full range of SEC enforcement authority.

Finally, the Enterprises' disclosure **will be available** from the SEC, the central repository for corporate disclosure reports of all registered companies. Today, Enterprise disclosures are provided to shareholders, investors and the public through various means-- paper documents, Internet and web site postings, wire service transmissions, or at their offices. This will be improved by availability in a central location. For example, since the Enterprises could not file insider transaction Forms Three and Four with the SEC, requests for the Enterprise equivalent documents had to be made to the Enterprises. Even though they ultimately were posted on the Enterprises' websites, I believe that it is important that the public have available a regulatory site to access such information for both companies.

The Process the Enterprises will Follow

The process for moving toward compliance with SEC rules will begin with the Enterprises filing a Form 10 Registration Statement. Once reviewed and effective, the entire spectrum of company reporting requirements contained in the '34 Act will apply to them. I believe this will produce many benefits.

1. One of the benefits to be obtained as the result of SEC registration should be a greater degree of uniformity in disclosures. This should facilitate comparison of the disclosures and financial statements of the Enterprises with each other and the comparison of Enterprise reports with those of other 12(g) registered companies. This uniformity will come about, in part, because all of the SEC required forms will have to be produced pursuant to the general rules regarding disclosures that are contained in SEC Regulation S-K.

2. Similarly, uniformity of disclosure should result in the area of financial statements required to be filed as a part of the Registration Statement under Section 12, in the Annual Reports under Section 13, and proxy and information statements under Section 14 that are governed by SEC Regulation S-X.

3. Periodic and other reports to shareholders under Section 13 will be required. This includes annual and quarterly reports (10K and 10Q), as well as special or current reports required because of material developments (8-K). SEC rules like 13a-1 governing the requirements of annual reports will apply for the first time.

4. Forward looking statements made in these reports will enjoy a safe harbor from liability if they comply with the provisions of Section 27A of the '34 Act, and Securities Exchange Act Rule 3b-6, governing liability for certain statements by issuers, provisions of law that until this registration, did not apply to the Enterprises. Application of these rules will ensure a regulatory discipline is imposed on the Enterprises.

5. Provisions of Section 13 of the '34 Act and Rules 13b2-1 and 13b2-2 governing accounting records and issuer representations will require the Enterprises to keep and maintain books, records and accounts in certain forms and for certain periods of time to ensure compliance with the federal securities laws and other federal statutes as well, such as the Foreign Corrupt Practices Act. Although the Enterprises maintain their own records today, SEC examination and inspection authority will be brought to bear and will supplement OFHEO's examination program to ensure that appropriate record production and retention programs are in place.

6. Enterprise proxy solicitation will become subject to Section 14 and Regulation 14A governing the form of proxies and solicitation materials and the manner in which the solicitation is conducted.

7. Pursuant to Section 16 of the '34 Act governing insider transactions, the officers and directors of the Enterprises will file Form 3 Initial Statements of Beneficial Ownership of Securities in their companies and each transaction will generate a requirement to file a Form 4 Statement of Changes in Beneficial Ownership of Securities. Annually, they will have to file a Form 5 Annual Statement of Beneficial ownership.

8. Should either of the Enterprises choose to make a tender for another company, or be the subject of a voluntary one, their transaction will be subject to Section 14 of the '34 Act and Regulations 14D and 14E will govern the format of materials and the manner in which the offer is conducted.

9. Finally, SEC rules governing interaction of issuers with the financial community of analysts, institutional investors and others will apply for the first time. OFHEO shares the concerns of the SEC that the highest standards of fairness be observed regarding the Enterprises' disclosures of investment relevant information. Now, for the first time, the Enterprises will be formally subject to Regulation FD that requires a public company to release any information, when it chooses to do so, in a way that the general public has access to it at the same time as institutional investors and analysts.

Next Steps

In order to facilitate the application of the '34 Act to the Enterprises, OFHEO will promulgate a rule concerning the filing of all required periodic reports. Registration with the SEC does not in any way limit OFHEO's ability to act in the interest of safety and soundness. Accordingly, as part of the rule I've mentioned, OFHEO is considering requiring supplemental disclosures beyond those required by the SEC.

In addition, OFHEO, the SEC and Treasury will conduct a review of disclosures relating to the offering of mortgage-backed securities by the Enterprises and other issuers. The review will consider the appropriate manner for creating a more level playing field, and greater comparability of disclosures that will enhance Enterprise safety and soundness.

I would note that OFHEO's goal is disclosure, not registration. Accordingly, OFHEO will not pursue a registration regime at this time. If our disclosure goals can be met without the need for registration, then registration is unnecessary. However, until this review is completed, we should not rule out registration in some form as a possibility. Finally, in response to the Subcommittee's request last week, I have conferred with the SEC and Treasury and we have agreed to make every effort to complete the review by year-end.

Examination Program

I will now turn to OFHEO's examination and supervisory review program. The Agency's examination program is continuous and conducted on-site. Results and conclusions are regularly communicated to the Enterprises' Boards of Directors and reported to Congress annually. The Agency's on-site examination process is augmented by formal surveillance and monitoring to provide context and greater focus for its on-site examination activities. These activities evaluate trends, analyze performance within the broader context of the marketplace and perform sophisticated analysis on features of risk at the Enterprises.

Key to the success of our effective examination program is an ability to keep pace with the speed of change in the financial markets and at the Enterprises. To do so, OFHEO must continuously improve its examination program and augment its examiners' skill expertise. In this connection, the Agency has a three-year plan to further enhance its skill palette and to position its teams of specialists to be prepared for areas of innovation and for emerging potential risks (e.g., E-Commerce, communication networks, augment evaluation of accounting practices). The Administration supports this plan.

Research and Analysis

In order to understand how changes in the market impact the Enterprises and conversely how changes in Enterprise operations impact the market, OFHEO also conducts sound and authoritative research and analysis. Much of our research builds on work already taking place within the other components of our regulatory regime and frequently builds upon work that has already been done.

The information and insights gained from our research and analysis shop helps OFHEO - - and Congress - - become even more proactive in its oversight of the Enterprises. This is critical given today's rapidly changing markets.

Permanent Funding

Mr. Chairman, you have been a strong supporter of OFHEO in terms of its ongoing budget requests and the need to be permanently funded. As you know, this would enable the Agency to have the flexibility to set resources - - on par with its other financial safety and soundness regulators - - in response to any rapid changes in the Enterprises or the markets. The Administration also supports this and has included it as a recommendation in its Fiscal Year 2003 budget request for OFHEO. While the Enterprises are well-run and well-managed companies today, we must keep pace given the demands of the ever-evolving marketplace. I look forward to working with you on this issue this year.

Conclusion

Mr. Chairman, thank you again for the opportunity to testify. As I stated in my testimony, OFHEO is moving forward with a strong and effective regulatory regime. Risk-based capital requirements are in place and working; our examination program continues to be strong and is perhaps the most highly regarded among financial regulators; and we are moving ahead in pertinent areas such as corporate disclosure, which are critical to the safety and soundness of the Enterprises as well as the overall viability of the markets. I would be pleased to answer any questions you or other Members of the Subcommittee may have.

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

FOR IMMEDIATE RELEASE
Thursday, June 27, 2002

Contact: Stefanie Mullin
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OFHEO ISSUES RISK-BASED CAPITAL STRESS TEST RESULTS FOR FANNIE MAE AND FREDDIE MAC

WASHINGTON, D.C. — Armando Falcon, Jr., Director of the Office of Federal Housing Enterprise Oversight (OFHEO), safety and soundness regulator for Fannie Mae and Freddie Mac (the Enterprises), announced today that both Enterprises passed the first application of the risk-based capital stress test.

"The risk-based capital stress test is a success," said Director Falcon. "It is a state-of-the-art capital standard performing the function Congress intended. The risk-based capital stress test requires the Enterprises to safely manage their risks or hold additional capital commensurate with their risk exposures," said Falcon. "With the proposal of the rule in 1999, the Enterprises began a program of managing their activities to ensure they would meet the requirements of the rule. Their prudent measures combined with favorable economic conditions have resulted in their passing the standard at this stage of the one-year implementation period."

OFHEO will not use the risk-based capital standard to classify the Enterprises for regulatory purposes until the end of the third quarter 2002. These results will be released in December. Starting then, an Enterprise will need to meet both its risk-based and minimum capital requirements to be classified as adequately capitalized. Until then, it need only meet its minimum requirement. However, OFHEO makes the following information available in the interest of public disclosure and regulatory transparency:

FANNIE MAE

As of March 31, 2002, Fannie Mae's risk-based capital requirement was $20.228 billion. Fannie Mae's total capital of $26.290 billion on that date exceeded the risk-based capital requirement by $6.062 billion. However, Fannie Mae's **higher** minimum capital requirement of $24.571 billion was binding.

FREDDIE MAC

As of March 31, 2002, Freddie Mac's risk-based capital requirement was $5.680 billion. Freddie Mac's total capital of $21.360 billion on that date exceeded the requirement by $15.680 billion. However, Freddie Mac's **higher** minimum capital requirement of $19.390 billion was binding.

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ANALYSIS

An Enterprise's risk-based requirement will vary from quarter to quarter depending on the Enterprise's risk management decisions and market conditions. Accordingly, and especially during this implementation period, it is reasonable for the Enterprises to take appropriate steps to ensure they maintain a comfortable capital cushion.

As of March 31, 2002, both Enterprises passed the stress test due to effective risk management including extensive interest rate hedging. Over the past three years since the risk-based capital rule was proposed, both Enterprises' use of derivatives increased dramatically. Fannie Mae's notional derivatives volumes rose 172 percent while Freddie Mac's volumes jumped 248 percent. The rule gives the Enterprises credit when they engage in effective risk management behavior. Freddie Mac's stress test results were especially strong because its hedges enabled it to maintain positive net interest income through nearly the full stress period in both interest rate scenarios.

The results also reflect the current relatively low-risk environment for the Enterprises. Because interest rates are low, the likelihood of very large changes is less than it would be in higher rate environments. In accordance with the statutory formula, the increase in the 10-year Treasury yield in the stress test as applied for March 31 is 371 basis points, less than the 600 basis point change applicable in higher rate environments. In the low interest rate scenario, the decrease in the 10-year Treasury yield is 247 basis points in the test, as applied for March 31.

The credit risk environment is also quite favorable. Rapidly increasing house prices in recent years have raised the value of the collateral on seasoned loans, which comprise most of the Enterprises' portfolios. Over the past three years, house prices have risen 24 percent, on average. A typical loan made in early 1998 with a loan-to-value ratio of 95 percent amounted to only 72 percent of the property value by March 2002. The risk default is, therefore, fairly low, and the severity in the event of default is also low. By comparison, house prices rose at only a 1.5 percent average annual rate in the early 1990s, and seasoned loans remained subject to much higher risk.

BACKGROUND

The **minimum capital standard** requires each Enterprise to have **core capital** (the sum of the par value of common and preferred stock, additional paid-in capital, and retained earnings) that meets or exceeds its minimum capital requirement (2.5 percent of assets plus 0.45 percent of adjusted off-balance-sheet obligations). Minimum capital represents an essential amount of capital needed to protect an Enterprise against broad categories of business risk.

The **risk-based capital standard** requires each Enterprise to have **total capital** (core capital plus general loss reserves) that meets or exceeds its risk-based capital requirement. Stress test results are calculated for two interest rate scenarios, one in which 10-year Treasury yields rise 75 percent and another in which they fall 50 percent. Changes in both scenarios are generally capped at 600 basis points. The risk-based capital level for an Enterprise is the amount of total capital that would enable it to survive the stress test in whichever scenario is more adverse for that Enterprise, plus 30 percent of that amount to cover management and operations risk.

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The risk-based capital rule was proposed in April 1999 and finalized September 13, 2001. The rule was further amended March 15, 2002. The rule will be used for capital classification starting with data for September 30, 2002. That number will be published at the end of this year. Both Enterprises were classified as adequately capitalized on March 31, 2002, and would have achieved that same classification had the risk-based standard been used, as well.

The tables below provide relevant capital data for each Enterprise as of March 31, 2002.

ENTERPRISE RISK-BASED CAPITAL RESULTS FOR MARCH 31, 2002
(Billions of dollars)

	FANNIE MAE		FREDDIE MAC	
Risk-Based Capital Requirement:				
High Interest Rate Scenario		18.475	5.680	
Low Interest Rate Scenario	20.228			1.481
Total Capital	26.290		21.360	
Surplus	6.062		15.680	

ENTERPRISE MINIMUM CAPITAL REQUIREMENTS FOR MARCH 31, 2002
(Billions of dollars)

	FANNIE MAE		FREDDIE MAC	
Minimum Capital Requirement	24.571		19.390	
Core Capital	25.500		20.558	
Surplus	.929		1.169	

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